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Horizontal and Vertical Equity in Taxation as Constitutional Principles:
Germany and the United States Contrasted*

by

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Part 1. Introduction.¹ Germany's Basic Law² assigns primary jurisdiction over constitutional issues³ to Germany's Constitutional Court⁴ and requires other courts to suspend their proceedings and refer constitutional issues that are critical to resolution of any pending case to the Constitutional Court.⁵ In the United States, the Supreme Court has broad appellate and, in some cases, original jurisdiction⁶ and its authority to review legislative action for conflict with the Constitution became clear early in the Court's history.⁷ Unlike Germany, however, lower courts also have jurisdiction to decide constitutional issues, subject of course to eventual Supreme Court review.⁸

¹ The tax law report for the XVIIth Congress of the International Academy of Comparative Law scheduled for July 2006 complements this article and provide a broader comparative review of constitutional tax law. The author of this article and general reporter for the tax program for the Congress designed the congress topic: Restricting the Legislative Power to Tax: Intersections of Taxation and Constitutional Law. (Program available at <http://www2.law.uu.nl/priv/AIDC/index1.asp>). For the national report from the United States that addresses some of the issues this article raises, see Tracy Kaye and Stephen Mazza, Restricting the Legislative Power to Tax, *Am. J. of Comparative Law* (2005).

² Das Grundgesetz in German. The term "Basic Law" tends to alternate with "Constitution" in the literature. The Basic Law serves the functions in Germany of the Constitution in the United States with the material difference that the procedure for amending the Basic Law is simpler than the emendation procedure for the U.S. Constitution. Compare Art 79 of the Basic Law that requires a two-thirds majority in each house of parliament to change the Basic Law with the US procedure under Article 5 of the U.S. Constitution requiring ratification by three-fourths of the state legislatures (or the electorates of three-fourths of the states). On the other hand, the Basic Law permits no amendments to Articles 1-20 that describe the basic rights although clarification and embellishment is permissible. Art. 146 anticipates that Germany eventually will adopt a constitution that will replace the Basic Law. Except as noted to the contrary, the English language text of quotations is from Press and Information Office of the Federal Government, BASIC LAW FOR THE FEDERAL REPUBLIC OF GERMANY (Christian Tomuschat & David Curry, trans) (1998).

³ Art. 93 of the Basic Law also gives the constitutional court authority to resolve conflicts between federal and state law and between the laws of different states.

⁴ Das Bundesverfassungsgericht in German. While the German Constitutional Court publishes its decisions, it does not disclose the names of the parties to the case as U.S. decisions do. Hence, German decisions become known by their citations or by some characteristic of the case. Customary citation form in Germany that this Article follows is "BVerfGE" (Decisions of the Federal Constitutional Court) followed by a volume number and a page number.

⁵ Art 100 establishes the referral process and requires the court involved to suspend the proceedings until the federal constitutional court resolves the constitutional issue. The Basic Law requires referral only if the constitutional issue is critical to the outcome of the case.

⁶ U.S. Constitution Art. III, Sec. 2.

⁷ *Marbury v. Madison*, 5 U.S. 137, 177 (1803) (establishing the Supreme Court's power to review legislative acts for constitutionality).

⁸ Rules of the United States Supreme Court, Rule 10 (2005) provides discretionary Supreme Court review of a decision of a U.S. Court of Appeals or the highest court of any state by writ of certiorari.

While the U.S. Supreme Court has resolved many tax controversies,⁹ with taxpayers raising constitutional questions in a number of cases addressing questions of federal tax law,¹⁰ only infrequently has the Court found a federal taxing statute to violate a constitutionally protected right or privilege.¹¹ Rarely has the Supreme Court looked to the Constitution and decided that a federal tax law violated the Constitution.¹² Never has the Supreme Court held a federal tax law to conflict with the Bill of Rights.¹³ Many more decisions involve challenges to state tax statutes as in conflict with the U.S. Constitution.¹⁴ Often those state law cases combine claims under several provisions of the Constitution, including the Commerce Clause,¹⁵ Due Process,¹⁶ and Equal Protection.¹⁷ In reviewing state tax statutes for compliance with constitutional standards, the Court consistently has applied its rational basis test, its least intrusive standard of review.¹⁸ Under that test, a statute is valid so long as the legislature has a rational basis

⁹ A recently assembled database identifies xxx Supreme Court decisions in federal tax matters during the years 1913 – 2000. Nancy Staudt and Peter Wiedenbeck's Supreme Court Tax Database (soon to be published on <http://law.wustl.edu>). The overall database seeks to identify all Supreme Court decisions addressing federal taxes during the years 1913 – 2000 and omits decisions addressing state taxes.

¹⁰ *Id.* (identifying 157 decisions in which the Court addressed Constitutional questions in resolving the federal tax issue. I am grateful to professors Staudt and Wiedenbeck for making the constitutional decisions' portion of the database available to me to use in this project. The total number of decisions is somewhat greater than 157, as the version of the database I used missed a few cases, including those cited in notes 152 and 153 *infra*. See discussion *infra* in Part 3.

¹¹ *Id.* The database discloses only 17 decisions in which the taxpayer won (some only partially) and several of those cases were criminal cases involving the issue of self-incrimination.

¹² *Eisner v. Macomber*, 252 U.S. 189 (1920) (determining that the 16th Amendment permits Congress to tax only realized gain); *Nichols v. Coolidge*, 274 U.S. 531 (1927) (limiting retroactive application of the estate tax on foreseeability grounds).

¹³ Amendments 1 through 9 of the U.S. Constitution protecting certain basic rights and individual liberties including freedom of speech, assembly and religion. On the history of the Bill of Rights generally, see Akhil Reed Amar, *The Bill of Rights as a Constitution*, 100 Yale L.J. 1131 (1991).

¹⁴ No one has compiled a database of these decisions so their number is less certain than for decisions involving federal taxing statutes.

¹⁵ U.S. Const. art. I, § 8, cl. 3. The Commerce Clause provides that Congress shall have the power "To regulate Commerce with foreign Nations, and among the several States, ..." Implicit in the grant of power to the federal government is the denial to the states of the power to burden interstate commerce, through discriminatory taxation, for example. *Am. Trucking Ass'ns v. Mich. PSC*, 125 S. Ct. 2419, 2422 (2005).

¹⁶ U.S. Constitution Amendment 5. The Due Process Clause reads in part: "No person shall ... be deprived of ... property, without due process of law..." U.S. Const. Amend. 14 applies the requirement of "due process" to the states: "nor shall any State deprive any person of life, liberty, or property, without due process or law."

¹⁷ U.S. Const. Amend. 14. last clause. The Equal Protection Clause reads in part: "nor deny to any person within its jurisdiction the equal protection of the laws. The Equal Protection clause is not part of the Fifth Amendment and the Supreme Court has held that it does not apply to the United States. *Steward Machine Co. v. Davis*, 301 U.S. 548, 584 (1937) (upholding the Constitutionality of the Social Security Act). The courts have determined that the equal protection clause of the 14th Amendment must be read into the 5th Amendment, *supra* note 16 (quoting the relevant part) so that the provision applies to the United States as well as the states. *Weinberger v. Wiesenfeld*, 420 U.S. 636, 638 n.2 (1975) (dictum stating that equal protection analysis under the 5th Amendment to be the same as under the 14th Amendment).

¹⁸ See discussion *infra* in Part 3B.

for its enactment.¹⁹ The decisions predominantly uphold the state taxing statute. Occasionally, the Court limits states' taxing power²⁰ or their tax collection authority over non-residents.²¹

The German Constitutional Court, on the other hand, has rendered many decisions in tax controversies on constitutional grounds.²² Those constitutional tax decisions have played and continue to play a meaningful and ongoing role in shaping tax law and administration in Germany.²³ The Constitutional Court employs a more exacting standard of review than rational basis and requires a compelling justification for legislation that results in any distributional inequalities causing like taxpayers to pay unequal amounts of tax.²⁴ In Germany, constitutional protections of individual liberties have rendered unconstitutional such matters as mandatory joint assessment of married couples,²⁵ retroactive application of rate increases,²⁶ deductibility of political contributions,²⁷ value-based taxes that do not apply the same valuation standard to all properties,²⁸ and income taxation of the subsistence minimum,²⁹ and, quite recently, a tax that the government was unable in practice to assess and collect uniformly.³⁰

¹⁹ *Western and Southern Life Insurance Company v. State Board of Equalization of California*, 451 U.S. 648 (1981) (holding a retaliatory state tax to be rationally related to the state's proper objectives). See discussion *infra* in text accompanying note 259.

²⁰ *Allegheny Pittsburgh Coal Co. v. County Commission of Webster County*, 488 U.S. 336 (1989) (prohibiting non-uniform assessment of tax on real property); *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564 (1997) (prohibiting taxing real estate of camp for non-residents of state while exempting real estate of camps for residents).

²¹ *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967) (limiting the state's power to impose collection responsibility for use taxes on non-resident vendors with no substantial presence in the state).

²² A database similar to the Staudt and Wiedenbeck database, *supra* note 9, is not available for the German decisions. However, the website for the university library at Marburg, <http://www.ub.uni-marburg.de/fachinfo/infjur03.html>, discloses that there is a looseleafed, reference work for the decisions of the German Constitutional Court, NACHSCHLAGEWERK DER RECHTSPRECHUNG DES BUNDESVERFASSUNGSGERICHTS.

²³ Decisions of Constitutional Court, however, have had little impact upon the structure and administration of the turnover tax (Umsatzsteuer) in Germany although the federal government raises roughly one-half of all its tax revenue through the value added tax. See, Bundesreferat I A 6, ERGEBNIS DER 122. SITZUNG DES ARBEITSKREISES "STEUERSCHÄTZUNGEN" VOM-4. BIS 6.-NOVEMBER-2003 IN FRANKFURT for statistics on distribution of collections. The turnover tax is substantially the same as a value added tax. This Article addresses the absence of constitutional decisions concerning the value added tax *infra* in Part 4F *infra*.

²⁴ BVerfGE 6, 55 (January 17, 1957), discussed *infra* in part 4B.

²⁵ *Id.*

²⁶ BVerfGE 13, 261, 271 (Dec. 19, 1961, 2d Senate), BVerfGE 13, 274 (December 19, 1961, 2d Senate) and BVerfGE 13, 279 (December 19, 1961, 2d Senate).

²⁷ BVerfGE 6, 273 (February 21, 1957) and BVerfGE 8, 51 (June 24, 1958).

²⁸ BVerfGE 93, 121 (June 22, 1995, 2d Senate) (holding the wealth tax, as applied to violate the equality principle); BVerfGE 93, 165 (June 22, 1995, 2d Senate) (likewise the inheritance tax), discussed *infra* in Part 4E.

²⁹ BVerfGE 82, 60 (May 29, 1990), discussed *infra* in part 4A.

³⁰ BVerfGE 110, 94 (March 9, 2004, 2d Senate), discussed *infra* in part 4C.

While the provisions protecting individual liberties and relationships are more extensive and detailed in the German constitution³¹ than in the United States constitution,³² that distinction may be one without a material difference. Both constitutions protect substantially identical groups of human rights, including speech, assembly, religion, personal dignity, racial equality and so forth.³³ Yet, the United States constitution has played at best an incidental and only indirect role in the development of U.S. tax law.³⁴

This Article explores how the German Constitutional Court and the United States Supreme Court approach constitutionally based arguments in their tax decisions. The Article focuses its attention primarily on distributional fairness in taxation. Most cases involving fairness issues address the equal rights guarantees in Germany³⁵ and the corresponding equal protection under U.S. law³⁶ or apply the rule of law provision of the German constitution³⁷ corresponding to the due process concept in the U.S.³⁸ The article seeks to develop hypotheses to account for the differences in approach and outcome in the two courts.³⁹

Part 2 of the Article introduces the basic tax equality concepts of horizontal and vertical equity and, in providing a brief overview comparing German and U.S. taxing structures, observes that neither system protects vertical equity (although Germany compensates in part for regressivity through its protected subsistence minima).⁴⁰ Part 3 examines the U.S. cases that address or resolve constitutional arguments under the U.S. Constitution. Part 3 emphasizes tax decisions applying the Bill of Rights and the

³¹ Art. 1-12, 13–17, and 20 describe and guarantee certain basic rights and liberties and include the protections found in the Bill of Rights, Amendments 1-9 of the U.S. Constitution.

³² Amendments 1-9, 13-15 to the U.S. Constitution.

³³ Art. 3 of the Basic Law guarantees equal rights without regard to sex in Germany. The U.S. constitution provides no similar protection but statutes and court decisions do. While a proposed amendment to the U.S. constitution failed to gather the approval of sufficient states to make it part of the constitution, U.S. Supreme Court decisions have applied equal protection analysis in striking down statutes that discriminated against women, for example, *Frontiero v Richardson*, 417 U.S. 677 (1973) (holding that requiring service women to establish their husband's dependency but not requiring husband's to do so with respect to their wives was unconstitutional), *Weinberger v. Wiesenfeld*, 420 U.S. 636 (1975) (holding that the Social Security Act discriminated against women who left surviving husbands and dependent children).

³⁴ See, generally, Boris I. Bittker and Martin J. McMahon, Jr., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶1.1 (1988).

³⁵ Article 3 of the Basic Law.

³⁶ U.S. Const. Amend. 14, Section 1. This amendment by its terms does not apply to the federal government but only to the states. Nevertheless, the courts have applied the equal protection principle to the federal government as well, *supra* note 17. William B. Lockhart *et al.*, *CONSTITUTIONAL LAW CASES—COMMENTS—QUESTIONS* at 1202 (1991).

³⁷ The principle of the rule of law (*das Rechtstaatprinzip*) flows from Art. 20 of the Basic Law: “[t]he Federal Republic of Germany is a democratic and social federal state. (Die Bundesrepublik Deutschland ist ein demokratischer und sozialer Bundesstaat.)

³⁸ U.S. Const. Amend. V and as applied to the states through Amendment 14, Section 1.

³⁹ Victor Thuronyi, *COMPARATIVE TAX LAW* 64-100 (The Hague 2003) (“Thuronyi” in the following) lays a foundation for comparative constitutional law study of taxation and discusses briefly the major German and U.S. cases.

⁴⁰ See discussion *infra* Part 4A.

Fourteenth Amendment to the Constitution. Part 3A describes a few taxpayer successes in non-Bill of Rights cases. Part 3B highlights how the Supreme Court rejects taxpayers' claims under the Bill of Rights in federal tax cases. Part 3C turns to taxpayers' challenges to state tax laws under the Fourteenth Amendment. Part 3D complements the discussion of the Equal Protection cases in Part 3C with some of the Supreme Court's Commerce Clause decisions where the Court tends toward a stricter equality standard. Part 3E reviews issues relating to the federal government's power to tax state activity and *vice versa*. A brief Part 3F glances at the screening process by which the Court insulates itself from "frivolous" constitutional arguments. Part 4 discusses decisions of the German Constitutional Court under the German Basic Law's due process, equal protection, human dignity and social state provisions. More specifically, Part 4A traces the constitutional jurisprudence limiting the power of the legislature to tax the subsistence minimum as a matter of equality and protection of human dignity. Part 4B examines the decisions that interdict marriage penalties on the bases of equality and protection of marriage principles. Part 4C describes and discusses the recent decision mandating practical ability to assess and collect a tax as a condition to its imposition on equality principle grounds. Part 4D looks to the Constitutional Court's approach to retroactive taxation under rule of law principles. Part 4E observes direct application of the equality principle to the Wealth and Inheritance Taxes. Part 4F reviews some Turnover Tax cases to demonstrate that horizontal equity in the turnover tax is required but vertical equity is not. Part 5 offers hypotheses to explain the reasons for the greater receptivity to constitutional challenges in the German Constitutional Court relative to the United States Supreme Court.⁴¹

Part 2. Overview comparison of the German and U.S. taxing structures. German tax legislation is predominantly federal. While the Basic Law reserves revenues from certain taxing sources to the states and municipalities⁴² and permits the states and municipalities to legislate in specific areas,⁴³ in practice, taxing legislation is federal. State and local legislatures can set some tax rates where federal legislation authorizes them to do so.⁴⁴ The principal taxes, income,⁴⁵ company,⁴⁶ and turnover,⁴⁷ respectively, are federal taxes

⁴¹ The Article will not address the relationship between Germany and the other members of the European Union or ongoing efforts to harmonize taxation throughout the European Union.

⁴² Basic Law Art. 106.

⁴³ Basic Law Art. 105.

⁴⁴ For example, section 25 of the Real Property Tax Law of 1973 (Aug. 8, 1973, as amended through December 12, 2000) [GrStG 1973, §25] (available at http://bundesrecht.juris.de/bundesrecht/grstg_1973/index.html) specifically authorizes the communities to establish the rate of tax, and to fix any increase from the previous calendar year no later than June 30 of any year.

⁴⁵ The Income Tax Law, version of Oct. 19, 2002, as amended through June 6, 2005 [Das Einkommensteuergesetz (Neugefasst durch Bek. v. 19.10.2002 I 4210, (2003 I 179), zuletzt geändert durch 28 G v. 21. 6.2005 I 1818)] (EStG followed by a section number in the following) (available at <http://bundesrecht.juris.de/bundesrecht/estg/index.html>).

⁴⁶ The Company Tax Law of 1977, version of Oct. 15, 2002, as amended through December 12, 2004 [Das Körperschaftsteuergesetz 1977 (Neugefaßt durch Bek. v. 15.10.2002 I 4144, zuletzt geändert durch Art. 4 G v. 15.12.2004 I 3416)] (KStG followed by a section number in the following) (available at http://bundesrecht.juris.de/bundesrecht/kstg_1977/index.html). The customary translation of the Körperschaftsteuer is the corporate tax but that seems an insufficient description for a reader in the U.S., as

that the Basic Law requires the federal government to share with the states⁴⁸ and the states to share with the municipalities.⁴⁹ The income and company taxes are direct taxes⁵⁰ on the income of individuals in the case of the income tax⁵¹ and the income of companies in the case of the company tax.⁵² Most tax commentators consider the turnover tax to be an indirect tax.⁵³ Its base is the value of goods or services and the taxable event is delivery of goods or services for compensation.⁵⁴ The statute allows a credit for the turnover tax paid earlier in the delivery process if the taxpayer received the goods or services for further distribution.⁵⁵ Accordingly, the burden of the turnover tax falls upon the ultimate consumer because the tax becomes part of the price.⁵⁶ The turnover tax is a consumption tax like the value added tax⁵⁷ and comparable to sales taxes common to almost all states in the United States.⁵⁸

By comparison, the United States integrates its individual and corporate income taxes into a single taxing structure under the Internal Revenue Code.⁵⁹ Nevertheless, the

the tax reaches all German limited liability entities as well, including the most common entity, the *Gemeinschaft mit beschränkter Haftung* (limited liability company). KStG § 1. Under U.S. tax law, limited liability entities are tax transparent (tax conduits) under subchapter K of the Internal Revenue Code of 1986, as amended (the “Code”).

⁴⁷ The Turnover Tax Law of 1980, version of February 2, 2005 [Das Umsatzsteuergesetz 1980 (Neugefasst durch Bek. v. 21.2.2005 I 386)] (UStG followed by a section number in the following) (available at http://bundesrecht.juris.de/bundesrecht/ustg_1980/index.html).

⁴⁸ Basic Law Art. 106, Para. 3.

⁴⁹ *Id.* Para. 5a.

⁵⁰ A tax is direct if the party who pays the tax also bears the burden of the tax. While an income tax is a classical direct tax, considerable disagreement concerning corporate income taxes arises because many economists argue that entities shift the burden of the tax to their customers through product and service pricing. Absent competition from non-taxable sellers and service providers, neither the entity, through decreased profits, nor its owners would bear the incidence of the entity level tax. Interestingly, that argument overstates the point, as even individuals who provide goods or services arguably could pass the incidence of income taxes on to their customers through higher prices so long as there is no non-taxable competition. Compare Thuronyi, *supra* note 39, at 54-7.

⁵¹ See, generally, Klaus Tipke & Joachim Lang, *STEUERRECHT*, Ch. 9 (17th ed. Köln 2002) (“Tipke/Lang” in the following).

⁵² *Id.* Ch. 11.

⁵³ *Id.* Ch. 14.

⁵⁴ UStG, *supra* note 47, § 1.

⁵⁵ *Id.* § 15.

⁵⁶ See, generally, Tipke/Lang, *supra* note 51, at 555.

⁵⁷ Value added taxes generally are imposed at each step in a distribution process on the increase in value that the taxable step adds. Customarily, the taxing statute either subtracts vendor’s purchase price from the vendor’s resale price and subjects that remainder to the tax or computes the tax on the vendor’s resale price and subtracts the value added tax paid earlier in the process. Thus, for example, a manufacturer buys raw materials that were subject to the value added tax and transforms them into a finished good. It is the increased value of the finished good over the raw material that is the subject of the tax.

⁵⁸ Sales taxes are also consumption taxes but differ from value added taxes as the taxable event is the purchase by the end user. The vendor collects the tax at point of sale by adding the tax to the sale price. Sales for resale are exempt from the tax. For example, see § 144.010 R.S.Mo. (defining sales at retail) and § 144.020 R.S.Mo. (imposing the tax on sellers engaged in the business of selling at retail).

⁵⁹ The Internal Revenue Code of 1986, as amended (the “Code” or “IRC” followed by a section number in the following), is Title 26 of the United States Code. Chapter 1 of the Code unifies the treatment of all income-based taxes, both individual and entity.

distinction between one taxing statute and two is insignificant.⁶⁰ The Code applies one set of rates to individuals⁶¹ and a different set to corporations.⁶² Numerous other differences between the rules applicable to individuals and those applicable to corporations permeate chapter 1 of the Code. For example, differing rules apply to various classes of deductions for individuals, but not corporations, as all corporate deductions are fundamentally trade or business deductions;⁶³ individuals receive an allowance for personal exemptions and corporations do not;⁶⁴ and a reduced rate of tax applies to individual's long term capital gains.⁶⁵ The German company income tax has a much broader reach than does the U.S. corporate income tax. All corporations in Germany are subject to tax at corporate level,⁶⁶ while corporations meeting specific ownership requirements in the U.S. may elect tax transparency, so that their owners are subject to tax on the entities' income rather than the entities themselves.⁶⁷ The German tax applies as well to all entities that enjoy any form of limited liability, including limited liability companies⁶⁸ and limited partnerships on shares.⁶⁹ Most similar entities in the United States such as limited liability companies and limited partnerships are transparent for federal income tax purposes but may elect to be taxed as corporations.⁷⁰

⁶⁰ A more significant difference lies in the administration of the tax, the United States relies on self-assessment, IRC § 6011, while the tax collector assesses all taxes in Germany. See, generally, Roman Seer, *BESTEUERUNGSVERFAHREN: RECHTSVERGLEICH USA-DEUTSCHLAND* 51-58 (Heidelberg 2002), for a brief explanation of the German assessment system.

⁶¹ IRC § 1.

⁶² IRC § 11.

⁶³ IRC § 62 applies only to individuals and allows certain deductions for individuals as adjustments to gross income, while other deductions are itemized deductions allowable in determining taxable income under IRC § 63 and allowable only if the individual elects to itemize. Individuals itemize if the deductions allowable under IRC § 63 exceed in the aggregate the standard deduction amount under IRC § 63(c). Corporations' deductions are allowable in arriving at taxable income under § 63 with no election to itemize and no standard deduction as an alternative.

⁶⁴ IRC § 151.

⁶⁵ IRC § 1(h).

⁶⁶ KStG § 1.

⁶⁷ Subchapter S of the Code, IRC § 1361 *et seq.* Corporations that may elect to be S corporations would not operate in corporate form in Germany at all. Most likely they would be limited liability companies (Gemeinschaften mit beschränkter Haftung) with stock companies (other than limited partnerships on shares – Kommanditgesellschaften auf Aktien) being only large, publicly traded entities in Germany.

⁶⁸ German limited liability companies are Gemeinschaften mit beschränkter Haftung (GmbH). While they are statutory entities in Germany as they are in the U.S., federal law authorizes and governs them in Germany. See, generally the Law governing Limited Liability Companies of Aug. 1, 1986, most recently amended July 19, 2002 (GmbHG in the following).

⁶⁹ Kommanditgesellschaften auf Aktien.

⁷⁰ Subchapter K of the Code, IRC § 701 *et seq.* governs partnerships, both general and limited, and provides for full tax transparency so that the entities' owners are taxable on their shares of the entities' income and the entities are not taxable. Treas. reg. § 301.7701-3 (2002) classifies U.S. limited liability companies as partnerships for federal income tax purposes but classifies most foreign limited liability entities as associations taxable as corporations for U. S. tax purposes. U.S. partnerships and limited liabilities may elect to be associations taxable as corporations, and foreign limited liability companies, including the German GmbH, may elect to be partnerships for U.S. tax purposes. Treas. reg. § 301.7701-3(c). Partnerships and limited liability companies that are publicly traded and engage in the active conduct of business rather than investment activities are treated as corporations for tax purposes. IRC § 7704. Treas. reg. § 301.7701-2, 3 resolved the classification issue in the U.S. The issue has a fascinating history in the

Although at times some legislators and tax theoreticians have proposed enactment of a national consumption tax,⁷¹ the United States has no national consumption tax.⁷² Most states, however, impose a consumption tax in the form of a sales⁷³ or gross receipts tax⁷⁴ on the sale of goods for consumption in the state. Sales of goods by an in-state vendor for delivery outside the state generally are exempt from the tax.⁷⁵ States having a sales type tax impose a complementary use tax in order to tax the consumption in the state of goods transported into the state for consumption that were not subject to sales tax in another jurisdiction.⁷⁶ With the exception of telecommunications services,⁷⁷ states generally impose no consumption-based tax on rendition of services within the state.⁷⁸ Accordingly, incidence of a consumption tax in the U.S. is far narrower than in Germany. In addition, the states determine their own rates of tax on sales,⁷⁹ so that the rates are not uniform as the rate is under the German turnover tax.⁸⁰

Vertical equity principles⁸¹ complement fundamental horizontal equity assumptions⁸² in both the German and U.S. income tax systems and underlie structural

U.S. See, generally, William S. McKee, William F. Nelson & Robert L. Whitmire, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶3.06-3.07 (1996).

⁷¹ Currently pending before Congress is a proposal to replace the Internal Revenue Code with a single, national sales tax. Fair Tax Act of 2003, H.R. 25 (108th Cong. 1st Sess). See William G. Gale, *The National Retail Sales Tax: What Would The Rate Have To Be?*, 107 TAX NOTES 889 (2005) (explaining the tax base and presenting economic data critical of the proposal). See, generally, *Rethinking the Tax Code*, Hearing before the Joint Economic Committee (108th Cong. 1st Sess) (Nov. 11, 2003) (includes statements promoting and opposing the value added tax); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICHIGAN L. REV. 807 (2005) (discussing consumption taxes); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095 (2000) (discussing various proposals for reform, including a value added tax).

⁷² See discussion *infra* in note 168 concerning whether a national consumption tax might be unconstitutional as a prohibited direct tax.

⁷³ Only Alaska, Montana, New Hampshire and Oregon do not impose a general, statewide sales tax or equivalent. 2003 ALL STATES TAX HANDBOOK ¶210 (2003).

⁷⁴ Illinois uses a retail occupation tax model and Delaware a gross receipts model. *Id.*

⁷⁵ 12 CSR 10-3.888 (2005) (delivery outside the state exempt from sales tax if buyer claims exemption).

⁷⁶ 2003 ALL STATES TAX HANDBOOK, *supra* note 73, ¶210

⁷⁷ Most states impose a tax on telecommunication services. *Id.* at ¶259.

⁷⁸ Exceptions exist for services of altering or installing a product but the imposition of the tax is not uniform from state to state. *Id.* at ¶253 shows a lack of uniformity in taxation of leasing of goods, ¶254 repair and installation, and ¶255-A for alterations.

⁷⁹ For those states that impose a statewide sales tax, rates range from Colorado's low of 2.9% to California's high of 7.25%. California includes a uniform 1.25% local tax while other states have varying local sales taxes in addition to the statewide tax. Thus, Mississippi and Rhode Island share the high end at a state level tax of 7%. *Id.* at ¶250.

⁸⁰ UStG § 12. Uniformity of consumption tax in Germany diminishes as local governments impose specialized consumption taxes on consumption of beverages, amusements, including hunting and fishing, ownership of dogs, etc. Basic Law Art 105, Para. 2a authorizes these local taxes.

⁸¹ Vertical equity is a means concept -- the greater the taxpayer's means as measured by income, the greater the share of the overall income tax burden the taxpayer should bear. Richard A. Westin, *WG&L TAX DICTIONARY* at 835 (2000). In its tax decisions, the German Constitutional Court remains mindful of vertical, as well as horizontal, equity principles. For example, BVerfGE 82, 60, *supra* note 29, at 89.

decisions that lead to an expressed, although not necessarily an actual, preference for progressive taxation in both countries.⁸³ While progressive taxation is the disproportional increase in taxpayers' tax burdens as those taxpayers' wealth and incomes increase,⁸⁴ this Article addresses progressivity relative to income, rather than wealth,⁸⁵ as it discusses the combined effect of income and consumption taxes. Thus, increasing tax rates as a taxpayer's amount of income increases signals the presence of progressive taxation.⁸⁶ Both German and U.S. personal income taxes employ graduated rate structures with positive rates in Germany ranging from a minimum of just over 16% (0% if one views capital gain as income) to a maximum of 45% (a 29% range)⁸⁷ and in the U.S. from a minimum of 10% to a maximum of 35% on ordinary income⁸⁸ and, with exceptions for certain categories of net capital gain,⁸⁹ a minimum of 5 percent⁹⁰ to a

⁸² Horizontal equity requires that identically situated taxpayers bear identical shares of the tax burden. Westin, *supra* note 81, at 338. Horizontal equity is conceptually neutral with respect to progression or regression in taxation.

⁸³ Progressive taxation injects vertical equity into the tax system by imposing a greater proportional tax burden, customarily through graduated rates, on taxpayers with greater incomes. For a concise discussion of progressive taxation in the U.S., see Walter J. Blum and Harry Kalven, Jr., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (Chicago 1953, revised 1963). See for Germany, Tipke/Lang, *supra* note 51, at 113 identifying the principle of redistribution of wealth through progressive taxation as a function of the social state principle, Basic Law Art. 20, rather than the equality principle, Basic Law Art. 3, that requires equal taxation of like situated taxpayers. And for an excellent overview of the literature and problems with progressive taxation debate, see Nancy C. Staudt, *The Hidden Costs of the Progressivity Debate*, 50 VAND. L. REV. 919 (1997).

⁸⁴ Blum & Kalven, *UNEASY CASE*, *supra* note 83, at 4.

⁸⁵ U.S. federal gift and estate taxes, chapters 25 and 20 of the Code respectively, are examples of taxes that are fundamentally progressive relative to wealth. Relative to income, however, both the gift and estate taxes may be regressive for several reasons. Gifts are excludable from the gross income of the recipient under IRC §102. Gifts of appreciated property from higher income tax bracket taxpayers to lower bracket taxpayers draw less income tax upon sale of the property than they would have if the higher bracket taxpayer sold the property because the donee becomes taxable on the gain. The donee takes the donor's adjusted basis in the property under IRC §1015 for purposes of determining the donee's gain. Gifts at death, however, eliminate the taxation of all historical gain in the property, as the donee's adjusted basis becomes the fair market value of the property at the date of the donor's death (or the alternate valuation date) under IRC §1014.

⁸⁶ Westin, *supra* note 81, at 555.

⁸⁷ EStG § 32a. Rates in Germany climb both in steps and in a linear progression that is a function of the amount by which a taxpayer's income exceeds the zero rate or exempt amount (*Grundfreibetrag*). For an explanation of the rate structure, see Tipke/Lang, *supra* note 51, at 426-27. Each taxpayer enjoys a basic zero bracket on the initial € 7,664 of income. While the statute employs the same terminology (*Freibetrag* – exempt amount) for the allowances for dependent children under EStG § 32, for example, those amounts reduce taxable income under EStG § 2, as do personal exemptions under U.S. tax law, IRC § 151, and, accordingly, retard the rate progression. On the other hand, various exclusions from income such as unemployment compensation, while exempt from tax, count toward determining the rate of tax on the next euro of income. EStG §32b.

⁸⁸ IRC § 1(a) – (d), (i). The rates set forth in IRC § 1(i) will return to the rates appearing in IRC § 1(a) after 2010, as provided in Section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (107th Cong., 1st Sess. 2001) (EGTRRA in the following).

⁸⁹ I.R.C. § 1(h) taxes unreaptured section 1250 gain, defined in I.R.C. § 1(h)(6), at a 25% rate and collectibles gain, defined in I.R.C. § 1(h)(5)(A), at a 28% rate.

⁹⁰ I.R.C. § 1202 excludes half the gain on qualified small business stock from gross income (a zero rate) and taxes the remaining gain at 28%.

maximum of 15% for net capital gain (a 25% range on ordinary income, but a 35% range integrating ordinary income and net capital gain).⁹¹ Germany also imposes a 5.5 percent surtax to support the cost of reunification,⁹² but generally does not tax capital gain.⁹³ Structurally, both the German and the U.S. income taxes appear progressive, as their rates increase with income.

The U.S. income tax, however, is somewhat more progressive in its rate structure than the German income tax.⁹⁴ Under the German income tax, all income in excess of € 52,152 (€ 104,304 for married individuals electing joint assessment) draws the maximum 45% rate,⁹⁵ while under the U.S. rate schedule, the rate brackets are broader and adjust for inflation⁹⁶ so that a married couple filing a joint federal income tax return reaches the maximum 35% rate on incremental taxable income only in excess of \$326,450 for the tax year 2005.⁹⁷ The U.S. does not use a linear progression as Germany does⁹⁸ but rather a series of five rate brackets⁹⁹ (six if one counts the zero rate resulting from the combined effect of personal exemptions¹⁰⁰ and the standard deduction¹⁰¹). Further, the U.S. income

⁹¹ IRC § 1(h). This net capital gain provision taxes various types of net capital gain at differing rates ranging at maximum from 15% to 28%. In addition, the range will narrow to 20-28% as the provisions of EGTRRA sunset, as set forth *supra* note 88. IRC § 1(h)(11) treats most corporate dividends as an increase to net capital gain taxed at the lower rates. IRC § 1222(11) defines net capital gain as the excess of net long term capital gains (§ 1222(7)), over net short term capital losses (§ 1222(6)).

⁹² Germany added the Solidarity Supplement Law in 1993 and replaced in 1995 (Solidaritätszuschlaggesetz 1995), currently, the applicable version was published October 15, 2002 and amended December 23, 2002.

⁹³ Tipke/Lang, *supra* note 51, at 390. Disposition of income producing property, capital gain, is disposition of the income source, not income. Thuronyi, *supra* note 39, at 236-7. In light of the recent Constitutional Court decision on assessment and collection, BVerfGE 110, 94, *supra* note 30, discussed *infra* in part 4C, even the limited inclusion of capital gains under the German system has become narrower.

⁹⁴ This observation may be somewhat surprising as one often associates a developed welfare system like Germany has with tax progression. Germany's taxes are higher than U.S. taxes so that Germany may support its welfare system, but they are not necessarily more progressive, just steeply progressive.

⁹⁵ EStG § 32a. Germany does not apply differing rate schedules to married and single individuals, so that joint assessment under EStG § 26b combines the incomes and then splits them into two taxpayers for computational purposes even though they remain jointly liable for the tax. Joint assessment renders spouses jointly and severally liable for the combined tax debt. Abgabeordnung (Tax Code) § 44 ¶ 1 (Version of October 10, 2002, most recently amended September 22, 2005) (Neugefasst durch Bek. v. 1.10.2002 I 3866; 2003 I 61 zuletzt geändert durch Art. 4 Abs. 22 G v. 22. 9.2005 I 2809) (available at: http://www.gesetze-im-internet.de/ao_1977/_44.html). Despite joint assessment, however, either spouse may request separate assessment on his or her separate income only at any time before payment in full of the jointly assessed tax liability. Abgabeordnung § 268.

⁹⁶ IRC § 1(f). The rate schedules under IRC § 1 (a) – (d) set the maximum rates for 1992, but the brackets adjust for the increase in the cost of living, measured by the Consumer Price Index for all-urban consumers that the U.S. Department of Labor publishes.

⁹⁷ IRC § 1(a) sets forth the 1992 level of \$250,000, and the bracket adjustments in 2005 under IRC § 1(f) will cause the maximum rate to affect married individuals filing jointly on their incomes in excess of \$326,450. Rates available at <http://www.irs.gov/formspubs/article/0,,id=133517,00.html>. For purposes of comparison, this Article assumes that the euro and dollar are equal in value. During much of 2002 a dollar was worth approximate 15% more than the euro and the converse has been true since 2003.

⁹⁸ *Supra* note 87.

⁹⁹ IRC § 1(a) – (d).

¹⁰⁰ IRC § 151.

¹⁰¹ IRC § 63(c).

tax includes a negative income tax feature for low-wage workers in the form of the earned income credit¹⁰² and Germany does not.¹⁰³

In addition, the personal exemption amounts and the standard deduction increase to reflect positive changes in the cost of living.¹⁰⁴ In upper income ranges, U.S. tax rules add further progression by phasing out the deduction for personal exemptions¹⁰⁵ and limiting the availability of various deductions for taxpayers who elect to itemize.¹⁰⁶ The German concept corresponding to U.S. personal exemptions are the basic exempt amount¹⁰⁷ and the exempt amounts for dependent children.¹⁰⁸ These exemptions are available to all taxpayers, including those with the largest incomes.¹⁰⁹

If one assumes middle and upper incomes in Germany and the U.S. are comparable, middle-income taxpayers in Germany tend to become less distinguishable from upper income taxpayers, than are their American counterparts, with respect to tax progression positioning. German middle-income taxpayers have the same basic exemption as the highest income taxpayers and the same dependency allowances as the highest income taxpayers with the same number of dependents. Since they reach the maximum rate of tax at only € 104,304, they tend to pay the same proportional tax as the

¹⁰² IRC § 32 provides a refundable credit for taxpayers within a narrow band of wage and self-employment based income.

¹⁰³ Lest a reader think the U.S. more generous in its welfare type benefits than Germany, Germany provides a broad range of direct subsidies to its low income and indigent citizens and lawful residents, including unemployment supplements, child supplements, social insurance, universal health insurance, government pension system. See, generally, Claus Offe, *The German Welfare State: Principles, Performance, Prospects* in John S. Brady, Beverly Crawford, and Sarah Elise Wiliarty eds., *The Postwar Transformation of Germany: Democracy, Prosperity, and Nationhood* 202 (Ann Arbor 1999).

¹⁰⁴ IRC § 151(d)(4) for personal exemptions and § 63(c)(4) for the standard deduction.

¹⁰⁵ IRC § 151(d)(4) reduces the personal exemptions by 2% for each \$2,500 of income over a threshold amount. The threshold is \$150,000 for married individuals filing joint returns. The EGTRRA, *supra* note 88, beginning in 2006 phases out the exemption's phase out subject to the sunset under section 901 of EGTRRA.

¹⁰⁶ IRC § 68 diminishes itemized deductions for higher income individuals thereby adding both progressivity and complexity. In addition, IRC § 67 limits certain deductions to their aggregate amount in excess of two percent of the taxpayer's adjusted gross income. The two percent floor grows with income and forces disallowance of ever greater amounts of those deductions. These features, phase-outs and deduction limitations, increase the effective rate of tax for taxpayers with specific characteristics. Some of the features create a tax bubble, that is, an increase in rate at certain income levels followed by a subsequent decrease in rate as income increases further. See, generally, Gregory G. Geisler and Ernest R. Larkins, *Current Year Tax Laws That Cause Low Visibility Of An Individual's Effective Marginal Tax Rate*, 101 TAX NOTES 627 (2003) and Martin A. Sullivan, *The Rich Get Soaked while the Super Rich Slide*, 101 TAX NOTES 581 (2003).

¹⁰⁷ EStG § 32a establishes the Grundfreibetrag.

¹⁰⁸ EStG § 32 (6) and EStG § 31 assures the non-taxability of a subsistence minimum for all taxpayers without regard to overall income.

¹⁰⁹ Decisions of the German Constitutional Court, BVerfGE 82, 60 (May 29, 1990), *supra* note 29, for example, preclude the German parliament from reducing or eliminating personal exemptions and the subsistence minimum exemption that the basic exempt amount embodies. See detailed discussion of these decisions *infra* in Part 4A.

upper income taxpayers.¹¹⁰ The German income tax approaches a two rate system applicable to all taxpayers, a zero rate on part of the income and 45% on the rest. By comparison, married U.S. taxpayers filing jointly with \$104,000 of taxable income would have three brackets representing together 140% of their rate before topping out.¹¹¹ And the phase-out of the personal exemptions would further distinguish the middle-income taxpayer, as there is no phase-out in Germany.¹¹²

Whatever progressivity the income tax introduces into the federal taxes in Germany and the United States, other features of the overall tax system undercut progressivity. The Constitutional Court, discussing the wealth tax, stated the principle that with respect to the individual's production: "the total tax burden remain ... a division of around half for private and half for public use."¹¹³ Germany raises approximately the same amount of tax revenue with its turnover tax as it does with its income tax.¹¹⁴ The turnover tax diminishes the progressivity present in the income tax by placing a larger proportional tax burden on lower income taxpayers than on higher income taxpayers. Lower income taxpayers lack discretionary income because they tend to have to expend all their income in order to provide for basic consumption of their necessities such as food, clothing, transportation and housing. Of those necessities, only

¹¹⁰ Extrapolating from some limited statistics available for 1998, it appears that between 4 and 5% of German taxpayers would be subject to the highest income tax rate in Germany while less than one-half of one percent would reach the highest U.S. rate on a euro-dollar equivalence. Verteilung der Markteinkommen und der Einkommensteuerschuld in Deutschland: Eine Auswertung anhand von einkommensteuerlichen Veranlagungsdaten, Tabelle 92 (available at http://www.sachverstaendigenrat-wirtschaft.de/download/ziffer/z822_846j03.pdf).

¹¹¹ Married taxpayers having combined income exceeding the minimum level for the maximum German rate of tax of € 104,000 (on a euro-dollar equivalence) represented approximately 8% of U.S. taxpayers who filed returns in 2002. Brian Balcovic, High Income Tax Returns for 2002, Table 2 (available at <http://www.irs.gov/pub/irs-soi/02hiinco.pdf>). Note that the estimates do not include individuals who do not file returns. Those with combined incomes exceeding the U.S. entrance to the top rate of \$326,450 represent significantly less than 2% of returns filed, as approximately 1.89% of the U.S. returns have income in excess of \$200,000 so that the number with income in excess of \$300,000 is significantly smaller. *Id.* at 6 and Table A.

¹¹² A phase-out would tax the subsistence minimum for taxpayers subject to the phase-out. Taxing the subsistence minimum violates the principle established in the Constitutional Court decisions discussed *infra* in Part 4A.

¹¹³ BVerfGE 93, 121, *supra* note 28, at 138 translating: "die steuerliche Gesamtbelastung ... in der Nähe einer hälftigen Teilung zwischen privater und öffentlicher Hand ..." (referring to the estimated yield from property for purposes of the wealth tax). Obviously, the split ignores the value added tax and the social insurance imposts. But see BVerfGE, 2 BvR 2194/99 (January 18, 2006), available at: http://www.bundesverfassungsgericht.de/entscheidungen/rs20051011_1bvr123200, rejecting a challenge to a combined effective rate of Income and Municipal Business (Gewerbesteuer, *infra* note 430) exceeding fifty percent as violating this fifty-fifty principle and holding that the 50-50 principle does not establish an absolute ceiling on permissible taxation.

¹¹⁴ Bundesministerium der Finanzen Referat I A 6, *supra* note 23, Tabelle 2. And see Statistisches Bundesamt Deutschland, "Kassenmäßige Steuereinnahmen Deutschland (available at <http://www.destatis.de/indicators/d/lrfin02ad.htm>) discloses that the turnover tax in 2003 produced approximate 21.5% of revenues while the personal income tax produced 35.9%. Adding other consumption taxes to the turnover tax, the percentage increases to 33.5%.

the rental expenditure for housing is exempt from the turnover tax.¹¹⁵ However, even in the case of rental housing, most tenants are not free from indirect taxes.¹¹⁶ Tenants generally bear the burden of their shares of the property owner's real property tax,¹¹⁷ as the property owner passes it along with other expenses through the rental price.¹¹⁸ Individuals with greater incomes may expend more overall and, therefore, pay more tax than the low income individual, but they are far less likely to expend all their income than are lower income individuals. Since money devoted to investment does not attract the turnover tax,¹¹⁹ the greater one's income, the smaller the percentage of that income that becomes subject to the turnover tax, as the taxpayer devotes an ever smaller percentage of her income to consumption. A tax burden that decreases as a proportion of income as income increases is regressive.

Germany's turnover tax, unlike its income tax, has no exemption amount but seeks to ameliorate its inherent regressivity through a dual rate system. The general turnover tax rate is sixteen percent¹²⁰ but a seven percent rate applies to many necessities including, public transportation¹²¹ and foodstuffs, other than those a vendor sells for consumption on the premises,¹²² but not clothing that is taxed at the full rate. The reduced rate applies without regard to the characteristics of the consumer, low income or high income. The reduced rate diminishes the tax burden on all taxpayers and may

¹¹⁵ UStG § 4 (12a) exempts rent from the turnover tax except for transient use of property, hotel rooms for example.

¹¹⁶ In the United States as well.

¹¹⁷ Grundsteuergesetz 1973 (GrStG in the following) § 1 authorizes the communities (municipalities) to determine the rate of tax so that the rate is not uniform throughout Germany. The community imposes the tax on the value of the real property, rather than directly on the rent that the owner derives from the real property, under GrStG § 2. Rent is the fee for services or sales price term for the price a buyer pays for the use of property. While the base for the property tax is property value rather than price for use, the real property tax, nevertheless, resembles a consumption tax in that the value of real property used to produce income is a function of the income, that is, the rent. Germany establishes valuation methodology statutorily with its valuation law (Bewertungsgesetz, Neugefasst durch Bek. v. 1. 2.1991 I 230, zuletzt geändert durch Art. 14 G v. 20.12.2001 I 3794, BewG followed by a section number in the following). The general valuation law confirms this relationship as valuation of residential rental property (BewG §76 (1) 1.) refers to BewG § 79 that begins with annual income and applies a multiplier. The multiplier relates to the type of use that produces the rent. BewG § 80 refers to the statutory supplements to fix the multiplier, and the statutory supplements are a function of the size of the community and the nature and age of the building construction.

¹¹⁸ A rental pricing model would anticipate that rent is a function of the landlord's costs, including property tax and maintenance, in providing the rental property plus profit, a pricing model that does not differ materially from the pricing of goods. While the landlord may fix the rent by examining the overall market, presumably the market generalizes the model. But models for pricing rentals abound and use a variety of formulae. See, for example, Bill Veneris, Setting Rental Rates is a Balancing Act, Rental Management (2004) (available at <http://www.rentalmanagementmag.com/newsart.asp?ARTID=1407>); Kenneth T. Rosen and Lawrence B. Smith, The Price-Adjustment Process for Rental Housing and the Natural Vacancy Rate, 73 THE AMERICAN ECONOMIC REVIEW 779 (1983); Joseph L. Pagliari, Jr. and James R. Webb, On Setting Apartment Rental Rates: A Regression-Based Approach, 12 THE JOURNAL OF REAL ESTATE RESEARCH 37 (2001).

¹¹⁹ UStG §4(8) exempts the sale of corporate stocks and bonds.

¹²⁰ UStG §12 (1)

¹²¹ UStG §12 (2) 10.

¹²² UStG §12 (2) 1. and Anlage (supplement).

introduce limited progressivity in the middle income range, as middle income taxpayers may spend a very large percentage of their income on consumption weighted toward the higher rate items. In addition, the amount of the subsistence minimum that remains exempt from income tax for all taxpayers presumably includes the various indirect taxes that individuals must pay.¹²³ Under the German definition of income that generally excludes capital gains,¹²⁴ regressivity would arise only with respect to high-income taxpayers who invest rather than consuming their income and then only *vis à vis* other middle or upper income taxpayers who consume a greater percentage of their respective incomes.¹²⁵

In the U.S., consumption taxes at state level inject regressivity into the combined federal and state tax system.¹²⁶ Like the German turnover tax, some of the state sales taxes use dual or multiple rate structures to ameliorate the regressivity of the sales tax¹²⁷ or burden limited types of expenditures more heavily.¹²⁸ Most states tax sales of goods but not performance of services under their consumption tax, leaving the taxation of services to the income tax while sales of goods are subject to both income and sales taxes. Low income individuals tend to consume proportionally fewer services than do high income individuals, so that this characteristic of the sales tax system adds additional regressivity overall. The Supreme Court has not held regressive taxation to be unconstitutional even though it determined that a graduated state tax on retail sales violated the equal protection clause because gross sales was not a measure of profitability to which a graduated rate tax might apply.¹²⁹

¹²³ Exemption of the subsistence minimum occurs through various exemptions, EStG §32, for example (describing various exemptions [Freibeträge], and the zero rate bracket [Grundfreibetrag], EStG §32a). The constitutional court identifies a relationship between indirect taxes and the amount of the subsistence minimum that defines the exempt amounts. BVerfGE 87, 153 at 156 (September 25, 1992, II Senat), discussed *infra* in text commencing with note 381. This Article discusses the dichotomy between mandatory and discretionary expenditures and the exemption of the mandatory expenditures (subsistence minimum) from the income tax *infra* in Part 4A.

¹²⁴ Unlike the U.S., Germany does not tax capital appreciation. *Supra* note 93. If, in order to generate a consistent measure of regressivity across taxing systems, one views capital appreciation or even only realized gains from the disposition of capital investments as income that draws a zero rate of tax, the presence of regressivity in the German system is likely to emerge relative to low income taxpayers as well as middle income taxpayers.

¹²⁵ See Appendix for this analysis.

¹²⁶ See notes 72 - 79 *supra* and accompanying text for discussion of those consumption taxes.

¹²⁷ For example, Illinois and Missouri reduce the rate for food. ALL STATES TAX HANDBOOK, *supra* note 73, at ¶250.

¹²⁸ Passenger car rentals in New York, liquor in Arkansas, for examples. *Id.*

¹²⁹ *Stewart Dry Goods Co. v. Lewis*, 294 U.S. 550, reh. denied, 295 U.S. 768 (1935) (Kentucky's graduated rate tax on gross retail sales violated equal protection because not rationally related with any certainty to ability to pay). See discussion *infra* in Part 3B.

At federal level, moreover, the social security,¹³⁰ self-employment¹³¹ and Medicare taxes¹³² introduce considerable regressivity into the tax laws because they tax income from wages¹³³ and self-employment,¹³⁴ but not investment,¹³⁵ and because the social security and self-employment taxes do not even reach all employment and self-employment income.¹³⁶ Employed, low income individuals pay social security tax even when they are exempt from federal income tax.¹³⁷ Congress designed the earned income credit,¹³⁸ in part, to compensate for the social security tax low wage earners would have to pay.¹³⁹ Through lower wages, employees tend to bear the burden of both their own and the employer's share of the social security tax.¹⁴⁰

Germany likewise has a series of wage and self-employment income based taxes to finance social insurance programs,¹⁴¹ including a national pension program,¹⁴² unemployment insurance,¹⁴³ universal health care insurance¹⁴⁴ and long-term care insurance.¹⁴⁵ Employer and employee make equal contributions with respect to the employee's salary. While the governing statutes call the payments contributions to

¹³⁰ IRC §§3101(a), 3111(a) [employee, employer respectively social security tax for old-age, survivors, and disability insurance]. See *Steward Machine Co. v. Davis*, *supra* note 17, 301 U.S. 548 (1937) (determining that the social security tax neither violates the uniformity clause, despite limitations on its applicability to specific industries and numbers of employees, nor reservation of powers to the states clause of U.S. Constitution Amend. 10 and is constitutional). Some argue that the social security tax, for example, is not a tax, even though it is an involuntary imposition. See Thuronyi, *supra* note 39, at 45 for discussion of what constitutes a tax.

¹³¹ IRC § 1401(a) [tax on self-employment income for old-age, survivors, and disability insurance]

¹³² IRC § 1401(b) [hospital tax on self-employment income], §§3101(b), 3111(b) [employee, employer respectively hospital tax].

¹³³ IRC §§3101(a), 3121(a) (defining wages).

¹³⁴ IRC §§1401(a), 1402(a) (defining self-employment income).

¹³⁵ IRC § 86 taxes as much as half the social security benefits that certain middle and higher income individuals receive and thereby adds a little progressivity in connection with social security benefits.

¹³⁶ IRC § 1402(b) defines self-employment income as limited by the Social Security Act section 230 contribution and benefit base so as to form the ceiling. The base does increase for inflation. Similarly, IRC §3121 limits wages for purposes of IRC §§3101(a) and 3111(a) in the same manner.

¹³⁷ William G. Gale and Jeffrey Rohaly, Three-Quarters Of Filers Pay More In Payroll Taxes Than In Income Taxes, 98 Tax Notes 119 (January 6, 2003).

¹³⁸ *Supra* note 102 and accompanying text.

¹³⁹ HR 2166, HR Report 94-19 at 10 (94th Cong. 1st Sess, Feb. 25, 1975) and more directly, S.Rep. 94-36 (94th Cong. 1st Sess, March 17, 1975) at 11 that reads in part: “[t]he credit is set at 10 percent in order to correspond roughly to the added burdens placed on workers by both the employee and employer social security contributions.”

¹⁴⁰ *Id.* The Senate report certainly suggests that Senate taxwriters believed that the employee bore the burden of both the employer's and the employee's share of social security taxes.

¹⁴¹ For general information on German social insurance programs, see Willem Adema, Donald Gray and Sigrun Kahl, Labour Market and Social Policy Occasional Papers – No. 58 – Social Assistance in Germany, OECD Document JT00137448 (2003), available at <http://www.oecd.org/dataoecd/2/60/34004521.pdf>.

¹⁴² With a contribution rate of 9.55% (19.1% total) on gross earnings up to €54,000. Germany 2002 – Tax-benefit country chapter – Benefits and Wages §10.2 (2004), available at <http://www.oecd.org/dataoecd/41/43/2491133.pdf>

¹⁴³ With a contribution rate of 3.25% (6.5% total) on gross earnings up to €54,000. *Id.*

¹⁴⁴ With a contribution rate of 7.00% (14% total) on gross earnings up to €40,500. *Id.*

¹⁴⁵ With a contribution rate of 0.85% (1.7% total) on gross earnings up to €40,500. *Id.*

insurance or pension plans, the imposts are mandatory not elective. So the payments are the equivalent of taxes as are the social security and Medicare taxes in the United States.¹⁴⁶ Also, like the United States, the tax base in each instance relates to services income but not investment income, so that the series of insurance payments tends toward the regressive. Germany's social insurance contributions distinguish themselves from United States contributions in that they have very moderate wage and self-employment income caps.¹⁴⁷

Both the German and the U.S. tax systems rely heavily on an income tax to raise governmental revenues. Within the income taxes, both systems appear to adopt the concept of vertical equity through progressive taxation. Yet, neither the German nor the U.S. tax system consistently adheres to progressivity as fundamental to tax structure. Rather both systems permit considerable regressivity in the combined impact of assorted taxes, the U.S. with its social security and self-employment taxes and Germany with its turnover tax. With that observation by way of background, notions of fairness that may underlie either or both systems must remain on the horizontal plane – tax fairness, and courts' intervention to assure fairness remains a matter of treating like taxpayers alike.

Part 3 The United States – Constitutional Arguments Generally Fail as to Federal Statutes but not State Statutes.

Although taxpayers have challenged federal tax classifications on equal protection grounds,¹⁴⁸ the database for a recent empirical study of U.S. Supreme Court decision-making in tax cases¹⁴⁹ discloses no case in which taxpayers were successful.¹⁵⁰ On the other hand, the Supreme Court was receptive to a due process challenge to retroactive application of the estate tax¹⁵¹ and the gift tax¹⁵² as applied to transfers at death or by gift before enactment of the tax. More recently, however, retroactivity arguments challenging the minimum tax¹⁵³ and a technical correction have failed.¹⁵⁴ Hence, unlike the German

¹⁴⁶ See *supra* note 130.

¹⁴⁷ *Supra* note 136 and accompanying text.

¹⁴⁸ *E.g.* *Regan v. Taxation Without Representation*, 461 U.S. 540 (1983) (unsuccessfully arguing that exclusion from I.R.C. § 501(c)(3) classification for lobbying denied equal protection *vis á vis* veterans organizations) discussed *infra* in text accompanying note 213.

¹⁴⁹ Nancy Staudt and Peter Wiedenbeck's Supreme Court Tax Database (soon to be published on <http://law.wustl.edu>), *supra* note 9. The database identified 157 decisions in which the Supreme Court resolved a case involving federal tax law on constitutional grounds.

¹⁵⁰ *Id.* There are, however, cases involving state taxation that the Court decided on equal protection grounds: *Allegheny Pittsburgh Coal Co. v. County Commission of Webster County*, 488 U.S. 336 (1989), (prohibiting non-uniform assessment of tax on real property); *Camps Newfound/Owatonna v. Town of Harrison*, 520 U.S. 564 (1997) (prohibiting taxing real estate of camp for non-residents of state while exempting real estate of camps for residents). *supra* note 20 discussed *infra* Part 3B.

¹⁵¹ *Nichols v. Coolidge*, 274 U.S. 531 (1927) (on foreseeability grounds).

¹⁵² *Untermeyer v. Anderson*, 276 US 440 (1928).

¹⁵³ *Darusmont v. United States*, 449 US 292 (1981) (holding that retroactive imposition within a taxable year of the minimum tax on tax preference items constitutional). See, generally, Charles B. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692 (1960), and,

constitutional court, the U.S. Supreme Court has proven unsympathetic to applying equal protection analysis to the distributive effects of taxing statutes and has retreated from earlier application of due process analysis to retroactive application of tax law changes.

Most constitutional federal tax jurisprudence involving no criminal question developed in the early decades of the post Sixteenth Amendment years. More than two-thirds of the federal law, constitutional decisions date to 1940 or earlier.¹⁵⁵ Of the post-1940 decisions, fully one-third involve criminal matters while none of the 1940 or previous decisions resolves a criminal issue.¹⁵⁶ Moreover, on federal questions, decisions predominantly have supported the government's power to tax. Taxpayers have won in the Supreme Court with constitutional arguments in only slightly more than ten percent of the cases that reached the Supreme Court (including the criminal cases).¹⁵⁷ And the Supreme Court in more recent year has overruled or limited its early decisions that were favorable to the taxpayer.¹⁵⁸ For example, the Court in 1988 firmly established the federal government's power to tax interest that states pay on their indebtedness¹⁵⁹ and Congress' power to limit the statutory exemption for interest on state obligations.¹⁶⁰ Taxpayers have enjoyed greater success in asserting limitations on a state's power to tax residents and non-residents differently¹⁶¹ and transactions involving interstate commerce.¹⁶²

A. Miscellaneous Taxpayer Successes. The U.S. Constitution requires that Congress apportion direct taxes among the states.¹⁶³ The Supreme Court resolved some of the uncertainty concerning the meaning of a direct tax as it rejected an early income tax insofar as it taxed income from real property.¹⁶⁴ The Court held that a tax on real

more recently, Brian E. Raftery, Comment: Taxpayers Of America Unite! You Have Everything To Lose - A Constitutional Analysis Of Retroactive Taxation, 6 Seton Hall Const. L.J. 803 (1996).

¹⁵⁴ United States v. Carlton, 512 U.S. 26 (U.S., 1994) (holding that retroactive application of a technical correction to a tax statute denying taxpayer a deduction does not violate due process).

¹⁵⁵ Staudt and Wiedenbeck's Supreme Court Tax Database, *supra* note 9.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ See United States v. Hatter, 532 U.S. 557 (2001) (overruling Evans v. Gore, 253 U.S. 245 (1920) with respect to operation of the Compensation Clause. See discussion *infra* in text accompanying note 182

¹⁵⁹ South Carolina v. Baker, 485 US 505 (1988), reh. den. 486 US 1062, discussed *infra* in text accompanying note 288.

¹⁶⁰ I.R.C. §103. Interest on local government obligations is also exempt from federal income taxation under I.R.C. §103 as local governmental units derive their authority and are federal law considers them to be part of the state from which they derive their authority. Jewell Cass Phillips, MUNICIPAL GOVERNMENT AND ADMINISTRATION IN AMERICA 36 (New York 1960).

¹⁶¹ Camps Newfound/Owatonna v. Town of Harrison, 520 U.S. 564 (1997) (prohibiting taxing real estate of camp for non-residents of state while exempting real estate of camps for residents). *supra* note 20; Metropolitan Life Insurance Company v. Ward, 470 U.S. 869 (1985). (rejecting Alabama's tax preference for in-state insurers, discussed *infra* Section 3C.

¹⁶² National Bellas Hess v. Department of Revenue, 386 U.S. 753 (1967) (limiting the state's power to impose collection responsibility for use taxes on non-resident vendors with no substantial presence in the state), *supra* note 21, discussed in Section 3D *infra*.

¹⁶³ Art. I, Sec. 2 [3] provides in part: "Representatives and direct Taxes shall be apportioned among the several States ... according to their respective Numbers"

¹⁶⁴ Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429, 583 (1895).

property certainly was a direct tax and concluded that a tax on the income from real property was the same as a tax on the property itself. Therefore it was a direct tax requiring apportionment.¹⁶⁵ On rehearing, the Court extended its holding to income from personal property.¹⁶⁶ Taxing that income also was a direct tax that, absent apportionment by population, the Constitution prohibited.¹⁶⁷ However, enactment of the 16th Amendment in 1913 removed the apportionment barrier to the income tax.¹⁶⁸

In an early post-16th Amendment decision, the definition of income confronted the Supreme Court. In *Eisner v. Macomber*,¹⁶⁹ a taxpayer successfully challenged imposition of an income tax on corporate dividends payable in the corporation's own shares – so-called “stock dividends.” Congress expressly included stock dividends in the tax base for the income tax, but the Court held that the 16th Amendment did not empower Congress to tax appreciation in the value of the taxpayer's property before the taxpayer's relationship to the property changed.¹⁷⁰ It is the change in the taxpayer's relationship to

¹⁶⁵ *Id.* at 583.

¹⁶⁶ *Pollock v. Farmers' Loan and Trust Co.* (rehearing), 158 US 601 622 (1895).

¹⁶⁷ *Id.* at 622.

¹⁶⁸ The 16th Amendment reads: “The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

Recently, the subject of direct taxes and apportionment has reemerged and led to renewed debate among tax commentators with respect to proposals in Congress and among tax commentators advocating national sales taxes or other consumption taxes. One commentator has argued that a consumption tax or value added tax might violate the apportionment requirement and is not covered by the 16th Amendment. Erik M. Jensen, *The Taxing Power, the 16th Amendment, and the Meaning of “Incomes,”* 33 *Ariz. St. L. J.* 1057 (2001). Another disagrees and insists that the direct tax/apportionment restriction had to do with slavery and has no continuing significance. Calvin H. Johnson, *Purging out Pollock: The Constitutionality of Federal Wealth or Sales Taxes*, *Tax Notes* 1723 (December 30, 2002). Their debate continued in further in *TAX NOTES* in 2003. Erik M. Jensen, *The Constitution Matters in Taxation*, *Tax Notes* 821 (August 11, 2003) and Calvin H. Johnson, *Barbie Dolls in the Archeological Dig: Professor Johnson Responds*, *Tax Notes* 832 (August 11, 2003). More recent additions to this discussion include Erik M. Jensen, *Interpreting the Sixteenth Amendment (by Way of the Direct-Tax Clauses)*, 21 *Const. Comm.* 355 (2004), Erik M. Jensen, *The Taxing Power: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION* (Westport, 2005), Calvin Johnson, *RIGHTEOUS ANGER OF THE WICKED STATES: THE MEANING OF THE FOUNDERS' CONSTITUTION* (Cambridge, 2005). Leo P. Martinez, *The trouble with taxes: fairness, tax policy, and the Constitution*. 31 *Hastings Const. L.Q.* 413-446 (2004).

Unclear from the language quoted in note 163 *supra* is whether a value added tax model of the consumption tax might be an indirect tax and not subject to apportionment at all, despite general acknowledgement that the burden of the tax fall upon the ultimate consumer of the goods or services that are subject to the tax, so long as its rate is uniform throughout the United States. Art. I, Sec. 8 [1] of the U.S. Constitution grants to Congress the power to tax “but all Duties, Imposts and Excises shall be uniform throughout the United States;” Other consumption tax models tax income but defer the imposition of any tax when the taxpayer invests, rather than consumes, the income. See discussion of the distinction between direct and indirect taxes *supra* note 50.

¹⁶⁹ *Eisner v. Macomber*, 252 US 189 (1920). For an extensive discussion of *Macomber* and the Constitution, see Henry M. Ordower, *Revisiting Realization -- Accretion Taxation, the Constitution, Macomber, and Mark to Market*, 13 *Virginia Tax Review* 1 (1993).

¹⁷⁰ In *Macomber*, *id.*, a corporation distributed a stock dividend to all common shareholders of record in the corporation, so that each shareholder's voting and participation rights remained unchanged despite the stock dividend. The shareholders received no cash or other property. The Court viewed taxing the distribution as taxing unrealized appreciation in the value of the shares.

the property that generates the taxable event. When the taxpayer sells or exchanges the appreciated property, the taxpayer's relationship to the property changes and a taxable event occurs. Similarly, when, in the case of a stock dividend as in *Macomber*,¹⁷¹ the taxpayers' rights relative to the rights of other shareholders change or may change, a taxable event occurs.¹⁷² Since the Supreme Court resolved the question in the taxpayer's favor in *Macomber* on constitutional grounds, Congress nevertheless has taken several steps toward taxing unrealized appreciation in mark to market rules applicable to commodities contracts¹⁷³ and inventoried securities.¹⁷⁴ Taxpayers have not challenged those statutes with the effort required to reach the Supreme Court and many commentators conclude that *Macomber* is no barrier to taxing unrealized appreciation.¹⁷⁵

While taxpayers consistently have lost federal tax cases in which they raised Bill of Rights claims,¹⁷⁶ taxpayers in recent years have met somewhat greater success with other constitutional claims. For example, the Supreme Court held that the Compensation Clause of the Constitution¹⁷⁷ is no barrier to imposition of a non-discriminatory tax on federal employees and other citizens, including judges, because there is no risk that Congress might impose the tax to influence judicial decisions.¹⁷⁸ In so holding, the Court overruled its earlier Compensation Clause decision that broadly prohibited imposing a new tax on judges' salaries.¹⁷⁹ The decision gave taxpayers a partial victory by permitting extension of the Medicare tax,¹⁸⁰ but not the Social Security tax,¹⁸¹ to sitting federal judges. The court distinguished the Medicare tax from the Social Security tax because the Social Security tax was discriminatory. Most other federal employees could elect whether or not to participate in social security, but judges and a limited group of high-level federal employees were required to participate in Social Security.¹⁸² Similarly, taxpayers successfully argued that the *ad valorem* Harbor Maintenance Tax¹⁸³ that the U.S. imposed on export shipments was indeed a tax¹⁸⁴ that the Export Clause

¹⁷¹ *Id.*

¹⁷² *Koshland v. Helvering*, 298 U.S. 441 (1936) (holding a dividend of common stock on preferred to be taxable); *Helvering v. Gowran*, 302 U.S. 238 (1937), reh'g. denied, 302 U.S. 781 (1938) (holding a distribution of preferred shares on common where preferred shares were already outstanding to be taxable).

¹⁷³ IRC §1256.

¹⁷⁴ IRC §475

¹⁷⁵ See Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 35 Ill. L. Rev. NW. U. 779 (1941); more recently, Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 Tax L. Rev. 355 (2004) (arguing that a realization based tax system makes sense but rejecting any constitutional realization requirement; but missing absence of evidence of change in the Supreme Court's view of the issue since *Macomber*). And to the contrary, Ordower, *Revisiting Realization*, *supra* note 169.

¹⁷⁶ *Infra* discussion in section 3B.

¹⁷⁷ The Compensation Clause guarantees federal judges a "Compensation, which shall not be diminished during their Continuance in Office," U.S. Const., Art. III, § 1.

¹⁷⁸ *United States v. Hatter*, 532 U.S. 557 (U.S., 2001).

¹⁷⁹ *Evans v. Gore*, 253 U.S. 245 (1920).

¹⁸⁰ I.R.C. §3101(b)(4)-(6).

¹⁸¹ I.R.C. §3101(a).

¹⁸² *United States v. Hatter*, *supra* note 178, 532 U.S. at 576.

¹⁸³ I.R.C. §4461.

¹⁸⁴ *United States v. United States Shoe Corp.*, 523 U.S. 360 (1998).

prohibited¹⁸⁵ rather than user fees. Likewise a nondiscriminatory federal excise tax on insurance premiums¹⁸⁶ violated the export clause insofar as it reached insurance premiums paid on export shipments.¹⁸⁷

B. Bill of Rights Decisions – Federal Law Challenges. Taxpayers enjoyed early victories with Due Process Clause arguments against retroactive application of the gift and estate taxes to gifts the taxpayer completed before enactment of the tax.¹⁸⁸ Those victories seem a function of lack of warning to taxpayers, rather than a reflection of a fundamental limitation on retroactive tax changes. Hence, the Court distinguished a change in the estate tax base that included gifts in contemplation of death¹⁸⁹ from the unanticipated, new tax, due process precedents.¹⁹⁰ The Court observed that retroactive application of the change worked no injustice. Gifts in contemplation of death were equivalent to transfers at death. The taxpayer reasonably could have anticipated the risk that Congress would change the law to include gifts in contemplation of death, as many states already included such gifts in their inheritance tax base.¹⁹¹ Compare the Supreme Court's early decision permitting the first, post-16th Amendment income tax statute to reach income the taxpayer realized during the taxable year before enactment of the statute but after adoption of the amendment to the Constitution.¹⁹² More recent decisions have given the United States still greater authority to impose tax law changes retroactively. For example, reduction of the decedent's unified estate and gift tax credit¹⁹³ for gift tax exemptions the taxpayer claimed under prior law was permissible¹⁹⁴ even though the tax

¹⁸⁵ The Export Clause states: "No Tax or Duty shall be laid on Articles exported from any State." U.S. Const., Art. I, § 9, cl. 5.

¹⁸⁶ I.R.C. §4371.

¹⁸⁷ *United States v. IBM*, 517 U.S. 843 (1996).

¹⁸⁸ *Blodgett v. Holden*, 275 U.S. 142 (1927); *Untermeyer v. Anderson*, 276 U.S. 440 (1928), *supra* note 152 (holding the imposition of the gift tax on gifts completed in the year of enactment of the gift tax but before introduction and enactment of the gift tax legislation to be impermissible retroactive taxation). Similarly, *Nichols v. Coolidge*, 274 U.S. 531 (1927) (imposing estate tax on gifts completed before enactment but structured that they would come within the statutory inclusion of gifts intended to take effect on death impermissible as retroactive taxation).

¹⁸⁹ Congress has since substituted an objective three year of death rule for the subjective concept of a gift in contemplation of death. I.R.C. §2035, as amended by P.L. 94-455, Sec. 2001(a)(5) (2d Sess. 1976). Compare, however, *Schlesinger v. Wisconsin*, 270 U.S. 230 (1926) (rejecting a 6 year of death presumption of contemplation of death), *Heiner v. Donnan*, 285 U.S. 312 (1932) (rejecting a 2 year of death presumption of contemplation of death). The current federal statute makes no presumption of contemplation of death. Rather it simply includes gifts made within 3 years of death in the decedent's gross estate.

¹⁹⁰ *Milliken v. United States*, 283 U.S. 15 (1931).

¹⁹¹ *Id.* at 22. And similarly with inclusion of life insurance proceeds in the decedent's estate when the decedent paid premiums. *United States v. Manufacturers Nat'l Bank*, 363 U.S. 194 (1960). But not where the right to proceeds of policies vested in the beneficiaries before enactment of the estate tax. *Lewellyn v. Frick*, 268 U.S. 238 (1925).

¹⁹² *Brushaber v. Union Pacific RR*, 240 U.S. 1, 24 (1916) (permitting the first income tax act to tax incomes retroactively to the date earlier the same year that the 16th Amendment took effect) and *Blodgett v. Holden*, 275 U.S. 142, *supra* note 188 (prohibiting retroactive application of the gift tax to a period before the Congress began to consider the tax) support this approach.

¹⁹³ I.R.C. §2010.

¹⁹⁴ *United States v. Hemme*, 476 U.S. 558, 571 (1986).

benefit of the claimed exemption disappeared as the gift became part of the decedent's estate under the three year of death rule.¹⁹⁵ In so holding, the Court expressly limited its earlier decisions to those instances in which the taxpayer had no notice of the change or contemplated change in the law before electing a course of action or Congress enacted a new tax.¹⁹⁶ And in upholding a retroactive extension of a state income tax to dividends that previously had been exempt, the Court observed in alluding to the planning issue with a retroactive gift tax "[w]e can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax ..."¹⁹⁷

Congress generally seeks to avoid the potential retroactivity problem by announcing publicly proposed tax changes and making them effective no earlier than the date of that announcement. However, where a taxpayer planned a transaction to exploit a flaw in a statute, neither the taxpayer's planning nor the absence of a public announcement in advance of the effective date of the change was a barrier to retroactive application of the statute as changed.¹⁹⁸ The statute in question and in effect at the decedent's death allowed a deduction for one-half the value of employer securities that an estate sold to an employee stock option plan.¹⁹⁹ The estate purchased shares on the market, sold them to an employee stock option plan and claimed the deduction – correctly applying the statutory provision as then in effect. The retroactive statutory change limited the statute to sales of shares that were includible in the decedent's estate, so the estate received no deduction. The Court viewed the change as a rational limitation of the statute to those instances that Congress originally contemplated reaching with the benefit targeting transition of ownership from decedents to employees of the business in which the decedent was involved before death. Retroactive application was modest and the change was not arbitrary.²⁰⁰

Taxpayers have fared no better in the Supreme Court with First Amendment based, religious freedom tax claims than they have with due process claims. With respect to the Establishment Clause and the Free Exercise Clause,²⁰¹ for example, the Supreme Court refused to exempt Amish taxpayers from the social security tax even though the Court acknowledged that their religious beliefs precluded the Amish from participating in any governmental social welfare system.²⁰² Free exercise of their religion had to yield to the need for uniform, non-discriminatory taxation to provide a fiscally sound social

¹⁹⁵ I.R.C. §2035 includes completed gifts that the decedent made within three years of death in the decedent's estate.

¹⁹⁶ *United States v. Hemme*, 476 U.S. at 567-8 (distinguishing *Blodgett v. Holden*, *supra* note 188, 275 U.S. 142, on the basis of surprise and limiting *Untermeyer v. Anderson*, *supra* note 188, 276 US 440 to enactment of wholly new taxes).

¹⁹⁷ *Welch v. Henry*, 305 U.S. 134, 148 (1938).

¹⁹⁸ *United States v. Carlton*, 512 U.S. 26 (1994).

¹⁹⁹ I.R.C. §2057 (repealed).

²⁰⁰ *United States v. Carlton*, *supra* note 198, 512 U.S. at 32.

²⁰¹ "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof;" U.S. Constitution Amendment I.

²⁰² *United States v. Lee*, 455 U.S. 252, 257 (1982).

security system.²⁰³ The Court similarly determined that religious organizations advancing racial segregation principles operated contrary to public policy²⁰⁴ and accordingly were not entitled to tax exempt status.²⁰⁵ The Court held that the fundamental policy against racial discrimination means that “[r]acially discriminatory educational institutions cannot be viewed as conferring a public benefit within the ‘charitable’ concept ...” that tax exempt status requires.²⁰⁶

Although the Supreme Court has never addressed directly the issue of whether the subsidy provided to churches through the federal income tax deduction violates the principle of church-state separation under the First Amendment,²⁰⁷ it permitted New York’s exemption of churches from property taxes to stand despite the state subsidy inherent in the exemption.²⁰⁸ On balance, absence of an exemption might lead to greater state entanglement because “[e]limination of exemption would tend to expand the involvement of government by giving rise to tax valuation of church property, tax liens, tax foreclosures...”²⁰⁹ And the Court has acknowledged that there is a subsidy in the charitable contribution deduction, but it is neutral with respect to the issue of religious establishment as it provides deduction for gifts to all religious as well as many secular entities.²¹⁰ Denial of the deduction for fixed fees for Scientology auditing, even if a fundamental religious practice, nevertheless was correct because the donor received a *quid pro quo* that is inconsistent with a charitable gift and similar to religious school tuition for which taxpayers receive no deduction.²¹¹

Freedom of speech claims²¹² that a public interest, lobbying organization advanced in favor of its right to receive tax deductible contributions also failed to persuade the Supreme Court.²¹³ The taxpayer enjoyed tax exempt status²¹⁴ but its lobbying activities precluded it from securing that type of tax exempt status that would allow its donors a deduction for contributions to the organization.²¹⁵ The Court also rejected the taxpayer’s argument that the statute denied the organization equal protection

²⁰³ *Id.* at 259-60.

²⁰⁴ *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983).

²⁰⁵ I.R.C. §501(c)(3). Contributions to organizations that do not have tax exempt status under I.R.C. §501(c)(3) are not deductible by the donor.

²⁰⁶ *Bob Jones Univ. v. United States*, *supra* note 204, 461 U.S. at 595.

²⁰⁷ I.R.C. §170 allows a federal income tax deduction for gifts to charities, including churches.

²⁰⁸ *Walz v. Tax Com. of New York*, 397 U.S. 664, 674-5 (1970).

²⁰⁹ *Id.*

²¹⁰ *Hernandez v. Commissioner*, 490 U.S. 680, 694 (U.S., 1989).

²¹¹ *Id.* at 693.

²¹² “Congress shall make no law ... abridging the freedom of speech ...” U.S. Constitution Amendment I.

²¹³ *Regan v. Taxation with Representation*, *supra* note 148, 461 U.S. at 545 (1983)

²¹⁴ I.R.C. §501(c)(4) exempts not-for-profit organizations that promote social welfare, among other activities, from the federal income tax.

²¹⁵ Generally, I.R.C. §170(c)(2) limits the charitable contribution deduction to organizations that are public charities and exempt under I.R.C. §501(c)(3). I.R.C. §501(c)(3) status is unavailable to any organization that devotes a substantial part of its activities to lobbying.

of the law²¹⁶ relative to veterans' organizations that could receive deductible contributions even though they engaged in lobbying.²¹⁷ The Court deferred to Congress' authority to discriminate among organizations to give a benefit so long as its basis for dissimilar treatment was rational.²¹⁸ The Court observed that Congress may have chosen veterans' organizations for additional tax benefits by making contributions to them deductible by the donor, despite the organizations' lobbying, because of their members' historical service to the country.²¹⁹

C. Bill of Rights Cases (Due Process and Equal Protection) – State Law Challenges. The early twentieth century saw many challenges to state taxes that included or relied on claims that the state tax violated due process and equal protection under the Fourteenth Amendment. Those due process and equal protection arguments met greater success when advanced against state taxing statutes than they did against federal statutes although the Supreme Court deferred generally to the state legislatures' choices with respect to their tax objects and structures. Using its least intrusive standard of review, the “rational basis test,”²²⁰ the Supreme Court struck down state taxing schemes only when the justices thought the classifications of taxpayers and tax objects to be arbitrary. The state could classify taxpayers and treat them differently from one another as long as it had a reasonable purpose for doing so.

While the United States Supreme Court has not addressed the issue of the so-called “marriage penalty”²²¹ under the federal income tax,²²² in *Hoeper v. Tax*

²¹⁶ U.S. Const. Amendment 14 reads in part: “nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.”

²¹⁷ I.R.C. §170(c)(3) allows a charitable contribution deduction for gifts to veterans' organizations, exempt under I.R.C. §501(c)(19), notwithstanding their lobbying activities.

²¹⁸ *Regan v. Taxation Without Representation*, 461 U.S. 540, *supra* note 148, at 550. The type of distinction does not require “strict scrutiny,” that is, a more stringent review than “rational basis” that requires a compelling state interest in the classification.

²¹⁹ *Id.* at 550-1.

²²⁰ On standard of review distinguishing the rational basis test from strict scrutiny that the Court applies to suspect classifications, see, generally, Lockhart et al., CONSTITUTIONAL LAW, *supra* note 36, Ch. 10.

²²¹ Marriage penalty customarily refers to the additional tax that a married couple pays than two single individuals with the same combined income. Thus, in a single income married household, joint filing permits income splitting and a lower tax than the comparable tax payable by an unmarried individual with the same income, but in a dual income married household, the combined income often causes the tax payable to be greater than the combined tax that two single individuals would pay. Compare IRC §1(a) (joint filing) with IRC §1(c) (unmarried, single filing). The rate bracket size for married individuals filing joint returns is less than twice the rate bracket size applicable to single individuals. IRC §1(f)(8) phases out the marriage penalty for the 15% marginal bracket only. The statute returns to its pre-2003 formulation, thereby restoring the marriage penalty at all brackets under the general sunset provision, section 901, of the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (1st Sess. 2001). Separate filing does not make the tax the same, as a separate rate bracket schedule applies to married individuals filing separate returns. The brackets for that schedule are exactly one-half the married filing jointly brackets and preserves the marriage penalty. IRC § 1(d).

²²² The Court denied certiorari in one instance. *Johnson v. United States*, 422 F.Supp. 958 (N.Ill. 1976), *aff'd per curiam sub. nom. Barter v. U.S.*, 550 F.2d 1239 (7th Cir. 1977), *cert. denied*, 434 US 1012 (1978). One may not assume that the denial of a petition for certiorari discloses anything concerning the Supreme

Commission of Wisconsin,²²³ the Supreme Court determined that a Wisconsin joint income taxation statute violated the due process clause. The statute in *Hoeper* required married couples to aggregate their incomes and pay tax according to a single rate schedule applicable to both single and married taxpayers. Graduated surtaxes caused the amount of tax payable to be greater than it would have been had each spouse's income been separate from the other spouse for tax purposes. The court viewed the aggregation as causing one taxpayer to become subject to tax on another person's income in violation of due process, as state law gave neither spouse an interest in the other's income as community property law would.²²⁴

With three justices dissenting, the Supreme Court expressly upheld sex-based tax discrimination at state level against an equal protection argument in *Kahn v. Shevin*.²²⁵ There a widower unsuccessfully challenged Florida's property tax exemption for widows, but not widowers. The Court found that the disparity between women's and men's incomes provided a rational basis for the state distinguishing and providing a

Court's view as to the substance of the case. Compare the German Constitutional Court's prohibition of mandatory joint assessment in BVerfGE 6, 55 (January 17, 1957), discussed *infra* in text accompanying and following note 415.

²²³ 284 U.S. 206 (1931).

²²⁴ *Id.* at 215. Against the backdrop of *Hoeper*, the district court in *Johnson v. United States*, 422 F.Supp. 958, *supra* note 222 carefully analyzed the federal marriage penalty against due process and equal protection arguments and concluded that the federal statute did not violate the Constitution. The court distinguished the statute in *Hoeper* from the federal statute that did not require married taxpayers to aggregate their incomes. *Id.* at 967-8. The leading Supreme Court precedents on the issue of the right to marry and privacy within marriage, for example, *Griswold v. Connecticut*; 381 US 479 (1965) (holding that the state may not restrict the freedom of the marital unit to use birth control devices), *Loving v. Virginia*, 388 U.S. 1 (1967) (striking down a statute that prohibited marriage between individuals of different races; *Boddie v. Connecticut*, 401 U.S. 371 (1971) (including the right to divorce within the fundamental right to marriage and limiting the application of a filing fee to indigent plaintiffs), led the court to conclude that marriage was a fundamental right, so the court had to apply strict scrutiny under the equal protection clause to the taxing statute as a burden on that right. *Id.* at 969-71. The court noted, however, that the courts give particular deference to legislatures' design of taxing statutes and noted further that the joint bracket schedule benefits some marriages while burdening others. *Id.* at 971-2. And see note 221 *supra* on the marriage penalty. Pointing out that statistical evidence demonstrates that most unmarried taxpayers do not live alone, the court handily rejected the government's argument that married taxpayers enjoy economies from maintaining a single household and can afford, therefore, to pay a higher tax. *Id.* at 972.

Nevertheless, the district court upheld the statute. Finding that the history of taxation provided the compelling interest necessary to support the burden on some married couples. The first income-splitting statutes permitted married individuals to pay a tax of twice the tax imposed at single rates on one-half the marital unit's combined income, thereby doubling the bracket size for the marital unit. (Germany continues to employ that true income splitting scheme with double rate brackets under its income tax. EStG §32a (5).) As a result of that structure, unmarried individuals reached the next bracket at twice the rate as married individuals with identical income in single income marriages. In order to diminish the disparity in income tax burden between single taxpayers and comparable single income marital units, Congress established the married filing jointly rate schedule. Further, Congress sought to treat all marital units the same whether single or dual income units by adopting the married filing separately schedule. The government's objective to achieve those two goals provided a sufficiently compelling government interest to support the marriage penalty. *Johnson* at 973. Taxpayers' appeal of the district court's decision proved fruitless. *Aff'd per curiam sub. nom Barter v. U.S.*, 550 F.2d 1239 (7th Cir. 1977), *cert. denied* 434 US 1012 (1978).

²²⁵ 416 U.S. 351 (1974).

discriminatory benefit for the class of widows in order to reduce ‘the disparity between the economic capabilities of a man and a woman.’²²⁶ In an earlier decision,²²⁷ the Court similarly upheld that a Georgia poll tax²²⁸ exemption for women, who do not vote, against equal protection challenge. The Court viewed the poll tax exemption as rationally related to statutory economic responsibilities because under Georgia law men were financially responsible for the family and thus would bear both the wife’s and children’s poll tax burden.²²⁹ The appellant did not raise, nor did the Court address on its own, the issue of whether the tax exemption might discourage women from exercising their recently acquired franchise in order to avoid the tax.²³⁰ The Court did emphasize that, in the case, the poll tax was not a disguise in order to deny men the right to vote by making payment of the tax a condition to voting registration.²³¹

Despite taxpayers’ failures to persuade the Supreme Court to invalidate statutes in several sex discrimination cases, there is a line of Supreme Court decisions prohibiting states from discriminating among classes of taxpayers. The bulk of taxpayer successes in those cases involves classifications that discriminate against non-resident taxpayers. Yet, there are several cases, like *Hoeper*,²³² for which residence is not a factor.²³³ For example, in *Allegheny Pittsburgh Coal Co. v. County Commission Of Webster County, West Virginia*,²³⁴ the Supreme Court held that the equal protection clause requires that the county assess property for tax purposes substantially uniformly. While no state statute specifically authorized the assessor to assess recently purchased properties at their arms’ length sale price but not increase assessments to reflect current market values of other properties, the assessor adopted that practice. Hence taxes remained stable for properties that did not change ownership and increased for properties that changed ownership. This practice created a large disparity in relative tax burden of similar properties in violation of equal protection.²³⁵ Later, when similar assessment disparities arose from Proposition 13 in California,²³⁶ the Court upheld the tax.²³⁷ The Court

²²⁶ *Id.* at 352.

²²⁷ *Breedlove v. Suttles*, 302 U.S. 277 (1937).

²²⁸ A poll tax is a capitation tax. *Westin*, *supra* note 81, at 529.

²²⁹ *Breedlove*, *supra* note 227, 302 U.S. at 282. The decision precedes most of the racial discrimination cases and includes language that later decisions would eschew: “[i]n view of burdens necessarily borne by them (men) for the preservation of the race, *Id.* The term “race” in the decision is probably racially neutral as referring to human race, although the appellant is: “a white male citizen 28 years old.” *Id.* at 279.

²³⁰ U.S. Const. Amendment 19, enacted in 1920, guarantees the right to vote without regard to sex.

²³¹ *Breedlove*, *supra* note 227, 302 U.S. at 284.

²³² *Hoeper v. Tax Commission of Wisconsin*, 284 U.S. 206, *supra* note 223.

²³³ *Davis v. Michigan Dep’t of Treasury*, 489 U.S. 803 (1989) (holding, but on statutory, not equal protection grounds, that a state may not tax retired federal employees’ pensions while exemption retired state employees’ pensions).

²³⁴ 488 U.S. 336 (1989). Compare the German Constitutional Court ruling the wealth tax unconstitutional because the valuation of real property failed to adjust for current market values, BVerfGE 93, 121, *supra* note 28, discussed *infra* in Part 4E.

²³⁵ *Id.* at 342-3.

²³⁶ Proposition 13 was a voter initiative that added Article XIII A to the California constitution in 1978. Article XIII A limits *ad valorem* taxes to one percent of the cash value of the real property as fixed in the 1975-6 assessment, subject to annual increase no greater than 2% per year. Following a non-exempt

distinguished *Allegheny* determining that the Proposition 13 limitation that created the disparity had the rational purposes²³⁸ of preserving neighborhood stability and protecting existing owners from rapid increase in taxes. A new owner did not require that protection because the new owner could decide not to buy in light of the expected increase in tax.²³⁹

Exclusions of specific types of workers and employers with fewer than eight employees from the Social Security tax and accompanying state unemployment taxes did not violate the equal protection clause because the exemptions bore a rational relationship to the purpose of the act.²⁴⁰ On the other hand, the Court rejected a distinction in a recording tax based upon the length of the mortgage and held the distinction between five years or more and less than five years to be arbitrary.²⁴¹ Yet, the Court accepted the statute's exemption, even for mortgages longer than five years, if the lender was a building and loan association.²⁴² Similarly, a business tax imposed on the gross receipts of a corporation but not on the gross receipts of an individual engaged in the same business was not acceptable under the equal protection clause since it was arbitrarily discriminatory.²⁴³ And, likewise, disparity in voting rights on tax matters as function of property ownership did violate equal protection.²⁴⁴

The Court has never held that equal protection requires vertical equity,²⁴⁵ so that equal protection neither demands progressivity nor prohibits regressivity in taxation.²⁴⁶ Both the federal government and the states have great flexibility in determining their rates and tax bases. A progressive rate structure received express approval from the Court.²⁴⁷ And, without addressing the regressive impact of its rate structure, the Court

transfer such as a gift from parent to child, reassessment to current cash value is permissible. Article XIII A also requires a vote of the people to approve any statutory tax increase in any California tax.

²³⁷ Nordlinger v. Hahn, 505 U.S. 1 (1992).

²³⁸ The Court rejected any higher level of scrutiny than rational basis to support the constitutional provision and implementing statutes. *Id.* at 11.

²³⁹ *Id.* The Court did not offer this latter rational in *Allegheny*. Note that the property tax increase on sale should adversely affect the sale price, as the buyer will have to pay a comparatively high tax. Moreover, the limit on assessment increases locks existing owners into their property, as moving within California is likely to cause them to pay materially higher real estate taxes.

²⁴⁰ Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 513 (1937) (, for example, exempting agricultural workers may be rational because of the administrative difficulties of collection).

²⁴¹ Louisville Gas & Electric Co. v. Coleman, 277 U.S. 32, 38 (1928).

²⁴² *Id.* at 40 (holding that the building and loan exemption serves the public purpose of encouraging home ownership).

²⁴³ Quaker City Cab Co. v. Pennsylvania, 277 U.S. 389, 402 (1928).

²⁴⁴ Hill v. Stone, 421 U.S. 289 (1975) (rejecting the Texas dual box system that required approval of bond issues and taxes by two classes of voters, one class consisting of owners of property subject to assessment in the municipality and a second class composed of the first class plus all non-owners. The system in effect provided super-voting rights to owners.)

²⁴⁵ Tax concept that "people with greater ability to pay should pay higher taxes." Westin, *supra* note 81, at 835.

²⁴⁶ See, generally, Leo P. Martinez, The trouble with taxes: fairness, tax policy, and the Constitution. 31 Hastings Const. L.Q. 413 (2004).

²⁴⁷ Brushaber v. Union P. R. Co., *supra* note 192, 240 U.S. at 25 (1916).

also upheld the Social Security Act.²⁴⁸ In the 1930s, the Court heard a series of chain and department store cases that involved state taxes basing graduation upon the size or the enterprise measured by either revenue or number of stores in the chain. In *Stewart Dry Goods Co. v. Lewis*,²⁴⁹ the Court took a harsh view of Kentucky's graduated tax imposed on gross retail sales stating: "the operation of the statute is unjustifiably unequal, whimsical and arbitrary,..."²⁵⁰ The Court distinguished a graduated rate structure applied to profit from one applicable to gross revenue because gross revenue provides no information about profit. The state's rationale that greater sales meant a greater ability to pay the tax was not rational.²⁵¹ The Court expressed a strong preference for a graduated income tax or a flat rate sales tax.²⁵² Similarly, the Court struck down a license tax that increased in amount on all stores in a chain whenever the chain opened a store in another county.²⁵³ To the contrary, Justice Cardozo, who dissented in *Stewart Dry Goods*,²⁵⁴ wrote the majority opinion in *Fox v. Standard Oil. Co. of New Jersey*²⁵⁵ upholding West Virginia's graduated, flat license tax, the amount of which per unit increased with the number of units in the chain of vendors. The Court considered the increase rationally related to the benefits that a member of a chain derives from the chain organization.²⁵⁶ Similarly, a graduated fee based upon the number of stores under the same ownership and management withstood challenge as well.²⁵⁷

The equal protection clause has played a greater role with respect to discrimination based upon residence. A New Mexico statute that provided an annual property tax exemption to Vietnam war veterans who were resident in the state on a specific date discriminated against non-residents who later became residents and denied equal protection to those veterans.²⁵⁸ Similarly, while a retaliatory tax on out of state insurers passed equal protection examination,²⁵⁹ an Alabama gross premiums tax that imposed a higher rate on out of state insurers in order to promote Alabama-based businesses violated equal protection standards.²⁶⁰ Unlike the California tax that was designed to promote interstate commerce by discouraging other states from imposing higher taxes on out of state insurers, Alabama's domestic preference tax created barriers

²⁴⁸ *Steward Machine Co. v. Davis*, *supra* note 17, 301 U.S. 548 (1937), *Helvering v. Davis*, 301 U.S. 619 (1937). And see discussion of the regressive structure of the tax *supra* in Part 2.

²⁴⁹ *Supra* note 129, 294 U.S. 550 (1935).

²⁵⁰ *Id.* at 557.

²⁵¹ *Id.* at 559.

²⁵² *Id.* at 563.

²⁵³ *Louis K. Liggett Co. v. Lee*, 288 U.S. 517 (1933).

²⁵⁴ *Supra* note 129, 294 U.S. at 566 (1935).

²⁵⁵ 294 U.S. 87 (1935).

²⁵⁶ *Id.* at 97.

²⁵⁷ *State Board of Tax Comm'rs v. Jackson*, 283 U.S. 527 (1931).

²⁵⁸ *Hooper v. Bernalillo County Assessor*, 472 U.S. 612 (1985).

²⁵⁹ *Western and Southern Life Insurance Company v. State Board of Equalization of California*, *supra* note 19, 451 U.S. 648 (1981). The case also establishes that discriminatory classifications of taxpayers require only a rational state interest and basis to withstand constitutional challenge under the Equal Protection clause rather than meeting a higher standard of constitutional review. *Id.* at 657.

²⁶⁰ *Metropolitan Life Insurance Company v. Ward*, *supra* note 161, 470 U.S. 869 (1985). And, similarly, *Wheeling Steel corp. v. Glander*, 337 U.S. 562 (1949) (invalidating Ohio's *ad valorem* tax on intangible property of a foreign corporation despite the statute's reciprocity provision).

to entry into the Alabama market that were “purely and completely discriminatory” against out of state insurers.²⁶¹ Moreover, the Court observed that the domestic preference tax bore no rational relationship to the state’s objectives. While the structure of the tax encouraged out of state insurers to invest in Alabama assets by reducing the tax rate relative to the level of Alabama investment, it did not require Alabama insurers to invest in Alabama assets at all.²⁶²

But even in those cases where geography is critical, the Court is reluctant to reject a state taxing scheme for which it can find a rational basis. When the tax scheme discriminates against in state taxpayers in order to encourage investment by out of state taxpayers by exempting them from tax, the Court finds no equal protection violation.²⁶³ Similarly, when the tax discrimination directly affects residents and only incidentally non-residents because it favors in state business, the Court has relied on state legislatures’ knowledge of local conditions and collection opportunities to uphold the tax.²⁶⁴ And an exemption from use tax for natural gas that local distribution companies enjoy while natural gas from both in-state and out of state independent producers is not exempt withstood equal protection challenge. The Court was unwilling to entertain the taxpayer’s argument that natural gas from an out of state local distribution company would be subject to use tax and held that the exemption was permissible regulation of natural gas distribution in order to protect that market.²⁶⁵

In an earlier decision, the Court found a rational basis in Vermont’s efforts to achieve a very rough equivalence between dividends from domestic corporations that were subject to Vermont franchise tax and foreign corporations that were not. Only dividends from foreign corporations were subject to income tax in Vermont. Yet, the discrimination against those dividends met equal protection standards because exempt Vermont dividends had borne an equivalent indirect tax burden through the franchise tax.²⁶⁶ The Court observed: “absolute equality in taxation cannot be obtained, and is not required under the Fourteenth Amendment.”²⁶⁷ In the same case, however, the Court held that Vermont’s exemption of interest earned from Vermont loans from tax discriminated against out of state loans in violation of the equal protection clause.²⁶⁸

Several decisions address challenges to formulary apportionment methods that states use to reach part of the income of out of state taxpayers. The Court held apportionment of railroad revenue based on the ratio of in state freight car miles to system car miles, to be an acceptable method under equal protection challenge.²⁶⁹ More

²⁶¹ *Id.* at 878.

²⁶² *Id.* at 882-3.

²⁶³ *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522 (1959) (exempting out of state taxpayers who store goods in Ohio from personal property tax).

²⁶⁴ *Madden v. Kentucky*, 309 U.S. 83 (1940) (upholding a tax on out of state bank deposits fivefold as great as the tax on in state deposits).

²⁶⁵ *GMC v. Tracy*, 519 U.S. 278, 306 (1997).

²⁶⁶ *Colgate v. Harvey*, 296 U.S. 404 (1935).

²⁶⁷ *Id.* at 422.

²⁶⁸ *Id.* at 425.

²⁶⁹ *Illinois C. R. Co. v. Minnesota*, 309 U.S. 157 (1940).

recently, Michigan's single business tax²⁷⁰ apportionment value added withstood both due process and commerce clause challenge that it discriminated against interstate commerce.²⁷¹ The formula was internally consistent.²⁷² The Court approved the three factor formula for income²⁷³ and the National Conference of Commissioners on Uniform State Laws adopted it for income that the Uniform Division of Income for Tax Purposes Act apportions.²⁷⁴ Since the tax is a tax on business operation in Michigan, the apportionment formula is not unfair.²⁷⁵

D. Commerce Clause Decisions. Many of the state taxation, equal protection cases include claims under the Commerce Clause as well. Application of the Commerce Clause to taxation matters conceptually overlaps due process and equal protection to prevent several states from unfairly taxing the same resources. Accordingly, the taxpayer must have sufficient contacts with the state to become subject to the state's taxing authority.²⁷⁶ This requirement of sufficient contact with the state became particularly important to the increasing volume of internet commerce. Congress, under the Commerce Clause, imposed a moratorium on taxation of internet activities that limits the states' authority to impose tax on internet access.²⁷⁷ The Multistate Tax Commission opposes extension of the moratorium, as well as further restrictions on the states' taxing authority.²⁷⁸

Taxpayers do win in the Supreme Court on Commerce Clause grounds when the state statute favors in-state over out of state taxpayers so long as the reason for the

²⁷⁰ Mich. Comp. Laws §208.1 (2005), (repealed for years beginning after 2009), as in effect at the time of the case, imposed a value added tax that apportions the value added that is subject to tax in Michigan for taxpayers operating in more than one state based upon three factors: property, payroll and sales.

²⁷¹ *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358 (1991).

²⁷² *Id.* at 380.

²⁷³ *Butler Bros. v. McColgan*, 315 U.S. 501, 509 (1942).

²⁷⁴ 7A U. L. A. 331 (1990 Cum. Supp.) (approved in 1957 by the National Conference of Commissioners on Uniform State Laws and the American Bar Association).

²⁷⁵ *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. at 380.

²⁷⁶ For example, *National Bellas Hess v. Department of Revenue*, *supra* note 21, 386 U.S. 753 (1967) and *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992) (prohibiting a state from requiring an out-of-state vendor having an insufficient nexus with the state to pay use taxes on its sales into the state. The vendor had not permanent establishment in the state).

²⁷⁷ Internet Tax Freedom Act. Act Oct. 21, 1998, P.L. 105-277, Div C, Title XI, 112 Stat. 2681-719; Nov. 28,

2001, P.L. 107-75, § 2, 115 Stat. 703, provides:

"Sec. 1100. Short title.

"This title may be cited as the 'Internet Tax Freedom Act'.

"Sec. 1101. Moratorium.

"(a) Moratorium. No State or political subdivision thereof shall impose any of the following taxes during the

period beginning on October 1, 1998, and ending on November 1, 2003--

"(1) taxes on Internet access, unless such tax was generally imposed and actually enforced prior to October 1, 1998; and

"(2) multiple or discriminatory taxes on electronic commerce.

²⁷⁸ Eric Parker, MTC to Congress: Stop Federal Preemption on Internet Tax Issues, 108 TAX NOTES 630 (2005) (reporting on Multistate Tax Commission opposition to pending legislation).

discrimination is to favor in-state individuals and businesses. For example, Hawaii's liquor excise tax discriminated against out of state producers in violation of the Commerce Clause.²⁷⁹ But Michigan's flat registration fee for trucks making deliveries in Michigan did not burden commerce. Taxpayers argued that the fee economically discriminated against truckers who made few deliveries in Michigan, as Michigan did not apportion the fee based upon mileage or some economic measure of the usage of Michigan roads.²⁸⁰

In addition, there is a line of cases under the Commerce Clause that distinguishes unitary from non-unitary business.²⁸¹ In the case of a unitary business, the state may apportion the taxpayer's income from its entire unitary business and tax the apportioned amount.²⁸² If the business is not unitary, the state may tax only the income attributable to activities within the state.²⁸³

E. State-federal taxing issues. The federal government's power to tax states and the states' power to tax the federal government have been issues of controversy over the years. The progression of cases demonstrates the Supreme Court's retreat from its early, broad-based rejection of inter-governmental taxation. Early Supreme Court decisions reflected the concern that the power to tax gave the federal government the power to control or destroy state and local governments, and conversely. An early case,²⁸⁴ held the Income Tax Act of 1894 unconstitutional as it taxed the interest on state and local bonds. In that case, the Court saw no difference between taxing income and taxing the source of the income and held that Congress lacked the power to tax municipal bonds.²⁸⁵ Subsequently, the Court held that taxing gain from the sale of state bonds, the interest on which was exempt from tax, would not undermine the state's ability to borrow or cost of borrowing.²⁸⁶ More recently, the Supreme Court overruled that part of the holding in

²⁷⁹ *Bacchus Imps. v. Dias*, 468 U.S. 263 (1984). The Court applied this rule retroactively to Georgia's excise tax in *James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529 (1991).

²⁸⁰ *Am. Trucking Ass'ns v. Mich. PSC*, 125 S. Ct. 2419 (2005).

²⁸¹ *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 781 (U.S. 1992) (finding no unitary business and relying on the indicia of a unitary business: functional integration, centralization of management and economies of scale). See, generally, Jerome R. Hellerstein and Walter Hellerstein, *STATE AND LOCAL TAXATION CASES AND MATERIALS* 562-565 (St. Paul 2001) (offering various formulations of the unitary business principle, not necessarily requiring operational interdependence but some integration of activities).

²⁸² *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983) (California's formulary apportionment of worldwide income permissible and fair as applied to a domestic corporation); *Barclays Bank Plc v. Franchise Tax Bd.*, 512 U.S. 298 (1994) (same, as applied to both domestic subsidiary of a foreign corporation and foreign corporation with foreign parent doing business in California). See, note 274 *supra* and accompanying text for the three factor apportionment method.

²⁸³ *Allied-Signal, Inc. v. Director, Div. of Taxation*, *supra* note 281, 504 U.S. 768; *Asarco, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982) (rejecting the state's attempt to apportion income from intangibles that were not part of a unitary business).

²⁸⁴ *Pollock v. Farmers' Loan & Trust Co.*, 157 US 429, reh., 158 U.S. 601, *supra* note 164.

²⁸⁵ *Id.* at 619. "...so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the States, and on their instrumentalities to borrow money, and consequently repugnant to the Constitution." *Id.* at 630.

²⁸⁶ *Willcuts v. Bunn*, 282 U.S. 216, 229 (1931).

*Pollack v. Farmers' Loan and Trust*²⁸⁷ and determined that Congress could choose to tax interest on state obligations.²⁸⁸

Taxation of the compensation of state employees followed a like development. Initially, the Court determined that taxing the salary of a state judge was impermissible taxation of the state, authority that the Constitution reserved to the state itself.²⁸⁹ Similarly, the Court held that a state may not tax an employee of the federal government.²⁹⁰ But the Court gradually narrowed the limitation²⁹¹ and ultimately overruled its early decisions, determining that intergovernmental tax immunity doctrine²⁹² was no barrier to a non-discriminatory tax on the salaries of federal employees.²⁹³ Such a non-discriminatory tax poses no threat to governmental functions.²⁹⁴ If, however, the tax discriminates in favor of employees of the state taxing government or against employees of federal government, it is unconstitutional not as a matter of equal protection, but because of the intergovernmental tax immunity principle.²⁹⁵ Discriminatory taxes potentially do undermine governmental functions by placing a greater burden on them than on state functions.

F. “Frivolous” Constitutional Arguments. Many constitutional claims that the German Constitutional Court might decide never reach the Supreme Court because the U.S. Supreme Court has greater control over its docket than does the German Constitutional Court.²⁹⁶ Even if a taxpayer makes a strong constitutional argument, the taxpayer may not compel the Supreme Court to hear the argument.²⁹⁷ Lower courts reject religious freedom arguments²⁹⁸ and protester arguments against the validity of the income tax and social security tax.²⁹⁹

The trend in the Supreme Court seems non-interventionist. Legislatures are best suited to make decisions with respect to tax classifications and structures. While the Court continues to accept cases where there is a conflict in the circuits concerning the

²⁸⁷ *Supra* note 164.

²⁸⁸ *South Carolina v. Baker*, 485 US 505, 525 *supra* note 159.

²⁸⁹ *Collector v. Day*, 78 U.S. 113, 128 (1871).

²⁹⁰ *New York ex rel. Rogers v. Graves*, 299 U.S. 401 (1937).

²⁹¹ *James v. Dravo Contracting Co.*, 302 U.S. 134 (1937) (permitting taxation of income from government contracts – federal); *Metcalf & Eddy v. Mitchell*, 269 U.S. 514 (1926) (likewise – state).

²⁹² *McCulloch v. Maryland*, 17 U.S. 316 (1819) (prohibiting the state of Maryland from taxing a United States bank).

²⁹³ *Graves v. New York*, 306 U.S. 466, 483 (1939).

²⁹⁴ *Id.* at 484-5.

²⁹⁵ *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803, 817 (1989) (holding that exemption of state retirees' pensions from the state income taxing while taxing federal retirees' pensions violates the constitutional principle of intergovernmental tax immunity).

²⁹⁶ *Supra* note 5 and accompanying text.

²⁹⁷ See discussion of discretionary jurisdiction by writ of certiorari *supra* note 8 and accompanying text.

²⁹⁸ In *Graves v. Commissioner*, 579 F2d 392 (CA6 1978), cert. denied, 440 US 946 (1979) (religious convictions against war did not support Quakers' claim for a war tax credit).

²⁹⁹ Broad range of cases. See, generally, Marjorie E. Kornhauser, *Legitimacy and the Right of Revolution: The Role of Tax Protests and Anti-Tax Rhetoric In America*, 50 *Buffalo L. Rev.* 819 (2002).

interpretation of a tax statute,³⁰⁰ the Constitution generally no longer comes into play unless a state taxing statute treats out-of-state taxpayers³⁰¹ or federal employees materially less favorably than its residents or state employees.³⁰²

Part 4. Germany – Human Dignity, Equal Rights and Due Process Tax Decisions

As the U.S. Supreme Court applies an unintrusive, rational basis review to constitutional questions in tax controversies,³⁰³ the German Constitutional Court examines tax legislation with a more critical eye. Unlike the Supreme Court's inactive role at the intersection of taxation and constitutional law development, the Constitutional Court has been instrumental in shaping fundamental elements of German income tax law³⁰⁴ and has prompted the legislature to abolish wealth, gift and inheritance taxes.³⁰⁵ The Supreme Court has grafted few constitutional limitations onto federal and state governments' taxing authority. Only the most arbitrary legislative selections of structure, base or taxpayer classifications fail to meet the Supreme Court's constitutional examination. Dissimilarly, the German Constitutional Court has applied Germany's basic law expansively and comprehensively to tax controversies. The court aggressively limits legislative authority in tax matters. The Constitutional Court has actively reviewed German federal tax legislation and has identified numerous basic law limitations upon the German Parliament's freedom to structure tax legislation, including a strict concept of equality in taxation under horizontal equity principles. But, while mindful of issues of vertical equity, the Constitutional Court has not read the Basic Law to require vertical equity; so that both progressive tax structures like the income tax and regressive tax structures like the turnover tax inhere simultaneously in the German tax law.³⁰⁶

A. Disposable Income – Equal Rights and Human Dignity. The first article of the Basic Law protects human dignity: “[h]uman dignity shall be inviolable. To respect and protect it shall be the duty of all state authority.”³⁰⁷ Combined with the social state principle,³⁰⁸ the Constitutional Court determined that the state must guarantee each citizen a subsistence amount consistent with human dignity.³⁰⁹ On the tax side, this

³⁰⁰ Supreme Court Rule 10, *supra* note 8.

³⁰¹ Part 3C *supra*.

³⁰² Davis v. Michigan Dep't of Treasury, *supra* note 295, 489 U.S. 803 (1989)

³⁰³ *Supra* Part 3.

³⁰⁴ Part 4A *infra*.

³⁰⁵ BVerfGE 93, 121 (June 22, 1995, 2d Senat) (holding that the valuation principles of the wealth tax violate Art 3 (equal rights) and the tax is confiscatory in violation of Art. 14 (property rights guarantee) as it applies to unproductive property); BVerfGE 93, 165 (June 22, 1995, 2d Senat) (holding that valuation principles in inheritance and gift tax laws inconsistent with Art. 3 (equal rights) as they do not reflect current values of all properties fairly). Discussion *infra* Part 4E. See also Thuronyi, *supra* note 39, at 329-30.

³⁰⁶ See discussion *supra* in Part 2.

³⁰⁷ Basic Law Art. 1 para. 1.

³⁰⁸ Basic Law Art. 20 para. 1.

³⁰⁹ BVerfGE 40, 121, 133 (June 18, 1975) (determining that the employment insurance fund need not provide for disabled orphans beyond age 25 and allowing the legislature to determine how to provide assistance to such individuals so long as each citizen receives social assistance to provide a subsistence

principle that the state has a duty to assure each citizen “the basic needs for a humane and dignified existence”³¹⁰ grew into a limitation on the power of the state to tax non-disposable income. As the discussion in the succeeding paragraphs clarifies, non-disposable income is that portion of the citizen’s income that the citizen must dedicate to providing the family with the necessities of life. Expenditures necessary to producing the income diminish income available for necessities.

A recent decision of the Constitutional Court develops from and elaborates upon the constitutional protection of non-disposable income.³¹¹ Under the German income tax law, taxpayers who maintain a second household because their place of employment is remote from the location of their principal residence may deduct the duplicative living expenses as an expense of income production.³¹² Similarly, taxpayers who receive supplementary payments from their employers to compensate for the additional cost of a second household when the employer assigns the employee temporarily to a remote location may exclude the payments from their income.³¹³ In 1995, effective for the tax year 1996, the legislature added a durational limit to the deduction or exclusion, so that expenditures for the second residence after two years of employment at the remote location ceased to be deductible and supplementary payments ceased to be excludable.³¹⁴ Designed to limit revenue loss from the dual household deduction and the exclusion from income of the supplementary payments, the durational limit assumed that taxpayers ordinarily would relocate their permanent residence to the employment location when the term of employment became permanent. More than two years suggests permanence and predominating personal rather than business reasons for continuing dual household maintenance.³¹⁵ United States tax law follows a similar pattern with respect to the deduction for temporary living expenses while an individual is away from home on business although the durational limit in a single location is one year.³¹⁶ However, unlike

consistent with human dignity), and, from the tax perspective, see BVerfGE 82, 60, 85, discussed in detail *infra* commencing with the text accompanying note 353 (requiring the exemption of a subsistence minimum from the income tax). An early case, however, did not support the premise of a state subsistence guarantee. BVerfGE 1, 97, 104 (December 19, 1951, 1st Senat) (denying a remedy under the human dignity, equality, family protection and social state principles for inadequate social welfare assistance to a war widow with dependent children who was unable to work).

³¹⁰ BVerfGE 40 at 133 translating “die Mindestvoraussetzungen für ein menschenwürdiges Dasein.”

³¹¹ BVerfGE 107, 27 (December 4, 2002).

³¹² EStG §9 ¶1, Nr. 5.

³¹³ Family separation payments (Trennungszuschläge) that do not exceed the amount deductible for duplicative living expenses are excludable. EStG § 3 Nr. 13.

³¹⁴ *Id.* and EStG §9 ¶1, Nr. 5.

³¹⁵ BVerfGE 107, 27 at 37 (discussing the reasoning of the Federal Financial Court (Bundesfinanzhof) for rejecting the taxpayers’ appeals of adverse lower court rulings). The Federal Financial Court (Bundesfinanzhof) is the highest appellate court for tax matters.

³¹⁶ IRC § 162(a)(2). U.S. taxpayers may deduct their expenses for meals and lodging when they are away from home on business. While the U.S. statute addresses the matter as expenses of travel away from home on business and does not grant expressly a duplicative living expense deduction, the statute limits the concept of temporarily away from home on business to a one year duration.

Germany, the United States allows no deduction to a U.S. taxpayer who changes her permanent place of employment even if separated from her family.³¹⁷

A married taxpayer whose principal place of employment differed from his spouse's principal place of employment successfully challenged the deduction's durational limit. The taxpayer was a professor who changed positions from a university in Frankfurt (Main), Germany to Berlin, Germany, but whose self-employed wife, for valid business reasons, retained her geographical center of business activity and household in Frankfurt.³¹⁸ The professor maintained a secondary, smaller residence in Berlin and sought to deduct his expenses for maintaining the secondary residence and for weekly trips home to Frankfurt.³¹⁹ In a companion case, the taxpayer was a criminal commissioner whom the state of Rhineland-Palatinate assigned to a national office in Berlin³²⁰ and who received a separation payment from the state that the taxpayer sought to exclude from income.³²¹ In both instances, the Constitutional Court concluded that the durational limitation violated the equality principle of the Basic Law.³²²

The Constitutional Court's decision built upon a fifty-year decisional history under the equality principle. While the court identified the fundamental taxation guidelines of horizontal and vertical equity that emanate from the equality principle and should drive taxation structures, only horizontal equity was critical to fair taxation.³²³ Vertical equity is important to the income tax classification but impractical for other tax bases.³²⁴ The court expressed the function of the guidelines as follows:

in the interests of constitutionally mandated equality of tax burden ..., taxpayers who have the same ability to pay should be taxed equally (horizontal tax equity), while (in the vertical direction) taxation of higher incomes should be *measured against* the taxation of lower incomes.³²⁵

³¹⁷ *Id.* After a year at most, the taxpayer's tax home shifts to the place of employment. Note, however, that Germany views some expenses as related to income production and deductible that the U.S. views as wholly personal and non-deductible, commuting expenses for example. Compare treas. reg. §1.162-2(e) with EStG §9 ¶1, Nr. 4.

³¹⁸ BVerfGE 107, 27 at 35.

³¹⁹ EStG §9, ¶1, Nr. 5. In addition to the deduction for duplicative living expenses allows a deduction for the cost of travel to the principal residence and back to the place of employment weekly.

³²⁰ BVerfGE 107, 27 at 35-6.

³²¹ EStG §3, Nr. 13. The separation payment is one to compensate the taxpayer for duplicative living expenses when the assignment is not sufficiently permanent to support permanent relocation.

³²² The equality principle (German: Gleichheitssatz) is in Art. 3, Para. 1 of the Basic Law and reads as follows: "[a]ll persons shall be equal before the law."

³²³ BVerfGE 107, 27 at 46-7.

³²⁴ *Id.* The court may emphasize income taxation because the case before it is an income tax case but, more likely, because other taxes, especially the turnover tax, by their nature tend to be regressive and, accordingly, vertically inequitable. See discussion of regressivity in the German tax system *supra* in Part II.

³²⁵ *Id.* at 46. Author's translation. Emphasis added.

Within the context of horizontal equity, the court determined that comparison of taxpayers' ability to pay is a function of net income.³²⁶ In determining net income, expenditures necessary to production of income generally are deductible³²⁷ but not expenditures that, while incidental and helpful to income production, relate to the taxpayer's specific standard of living and personal choices.³²⁸ For example, a taxpayer may deduct duplicative living expenses necessary to employment at a location remote from home.³²⁹ Yet, the allowable deduction may not exceed some average or customary level of living expenses that does not take the taxpayer's individual standard of living choices into account, even if extravagant or luxurious expenditures are more consistent with the taxpayer's general standard of living and possibly necessary in order to meet the expectations of the taxpayer's business contacts. The court viewed the excess expenditures over some general standard of living as discretionary and non-deductible rather than deductible mandatory expenditures.³³⁰

The dichotomy between mandatory and discretionary expenditures, according to the court, determined the permissibility of the state's taking the funds through taxation that the taxpayer otherwise would devote to the expenditure.³³¹ Although ordinary living expenditures generally are not deductible,³³² citing its earlier decisions, the court pointed out that aspects of childcare and education expenditures are not discretionary and, accordingly, funds necessary for them not taxable to the degree that fully discretionary funds are.³³³ With respect to income production, certain expenditures that are personal in nature are essential, that is non-discretionary, to income production and, therefore, deductible. As an example, commuting expenses are deductible although the selection of the location of one's residence, and, indirectly commuting cost, is personal.³³⁴

³²⁶ *Id.* at 47.

³²⁷ EStG §9.

³²⁸ EStG §12 Nr. 1 (disallowing deduction for expenditures associated with the taxpayer's standard of living even if they contribute to the production of income).

³²⁹ EStG §9, ¶1, Nr. 5.

³³⁰ BVerfGE 107, 27 at 48.

³³¹ The mandatory, and, therefore, non-taxable expenditures group themselves around a subsistence minimum that the court discusses in detail in its decision, BVerfGE 87, 153 (September 25, 1992, 2d Senat), *infra* note 381, and accompanying text.

³³² EStG §12, Nr. 1.

³³³ BVerfGE 107, 27 at 49. The court cites its earlier decisions at BVerfGE 89, 246, 253, discussed *infra* in text accompanying note 395, (accepting an incremental needs standard in fixing the subsistence minimum that the income tax must exempt, while the social welfare system used a *per capita* system) and BVerfGE 82, 60, 86, discussed *infra* note 353 and accompanying text (observing that a subsistence minimum must remain free from the income tax). By comparison, the United States takes an ambiguous approach to childcare expenditures, allowing a credit for a portion of dependent care expenses for some taxpayers under IRC §21.

³³⁴ *Id.* at 50. EStG §9, ¶1, Nr. 4 permits a deduction for commuting costs. Under U.S. tax law, commuting costs are personal and non-deductible. Treas. reg. §1.162-2(e). Parking expense, however, is deductible if the employer arranges for the employee to pay for parking through a compensation reduction arrangement under IRC §132(f)(4).

The preceding analysis took the court to the duplicate living expense issue. The Finance Committee of the Bundesrat that introduced the two-year time limitation saw deductibility of temporary living expenses of a second household as a matter of legislative grace recognizing the business necessity that affects ability to pay tax. On the other hand, the Committee saw attribution of long-term dual housekeeping at a single work location to business necessity to be a fiction.³³⁵

The Constitutional Court, however, considered the two-year durational limit to be inconsistent with business reality in the case of the criminal commissioner because the court was unable to distinguish multiple extensions of a taxpayer's assignment to a single work location³³⁶ from a series of assignments lasting more than two years in the aggregate to a series of different locations. In both instances, the uncertainty of temporary assignments rendered permanent relocation impractical.³³⁷ Since the statutory distinction between a single location and multiple locations caused the deduction limitation to treat similar abilities to pay dissimilarly by treating the multiple location worker more favorably than the multiply assigned, single location worker, that statutory distinction violated the equality principle.³³⁸

The two-year durational limitation on the deduction for dual household costs also was flawed as it applied to married individuals both of whom work outside the home.³³⁹ If the spouses' principal occupation locales differ, the expense of maintaining a second household is an income production expense that the tax law must take into consideration without regard to the duration of the arrangement. The court compared two families with similar spousal combined earnings. Both families may incur duplicative living expenses in order to produce income when one spouse changes his or her place of employment. Initially, the tax law acknowledges that the dual expense is a cost of producing income and allows a deduction.³⁴⁰ The single earner family may eliminate the duplication because the family may relocate to the new place of employment. If the family chooses to continue to maintain a dual residence, the dual residence expenditure is clearly discretionary. On the other hand, maintenance of dual residences is mandatory for the dual earner family so long as the spouses' respective places of employment differ from one another. Accordingly, a two-year durational limit to the deduction was not rational, as it limited a deduction for non-discretionary expenditures necessary to the continued production of income. By treating discretionary and non-discretionary expenditures the same, the tax law failed to distinguish between dissimilarly situated taxpayers and violated the Basic Law's equality principle.³⁴¹ So while the statute purported to treat the

³³⁵ *Id.*

³³⁶ The commentary on the case refers to it as the Kettenabordnung decision (chain delegation or assignment decision) because it involves the several delegations of the taxpayer to the same work locale but no permanent assignment. The court uses the term "Kettenabordnung" in referring to the criminal commissioner's serial assignments. *Id.* at 52.

³³⁷ *Id.*

³³⁸ Basic Law Art. 3 Para. 1.

³³⁹ BVerfGE 107, 27 at 52-3.

³⁴⁰ EStG §9, ¶1, Nr. 5.

³⁴¹ Basic Law Art 3.

families identically, it failed to account for a material and non-discretionary expenditure.³⁴² With respect to other non-discretionary expenditures, the tax law permitted deductions to both spouses for other duplicative career expenditures such as commuting expenses.³⁴³

While the equality principle may have sufficed to enable the Constitutional Court to find the durational limit for dual household expenses unconstitutional in both cases, the court, nevertheless, relied heavily in the two career case on the family and marriage protection principle in rendering its decision.³⁴⁴ Insofar as the durational limit assumes that the family normally would move to the work location of one spouse, it denies the family the ability to create its own structure. Ability to relocate is a function of the specific marital model that includes only a single wage earner.³⁴⁵ The court rejected such a model as a justification for tax rules four decades earlier.³⁴⁶ The court concluded that tax legislation must respect the basic right of families to select their own structures, dual earner or single earner, and treat all the structures the same based upon ability to pay given the freely chosen structure.³⁴⁷

How far taxpayers will push the limits of the decision should prove interesting. The court's language on both the mandatory-discretionary distinction is broad, as is its language on freedom to structure the family. Taxpayers seem likely to test the mandatory expenditure analysis by claiming a miscellany of essential payments as mandatory and deductible. In the U.S. a taxpayers' organization would quickly emerge to finance litigation to expand the scope of the deductible, mandatory expenditure concept. Similarly, a variety of family structures would soon claim deductions for duplicative living expenses. Claim of a deduction for the continued maintenance of separate residences for couples who are working in different locations at the time of marriage seems a logical next step.

Nevertheless, the dual household case broadened the range of expenditures that the court viewed as non-discretionary and, accordingly, not subject to the income tax.³⁴⁸ Earlier Constitutional Court decisions distinguished mandatory or non-discretionary expenditures from discretionary expenditures that constitute disposable income.³⁴⁹ From an American perspective, those decisions reached the remarkable conclusion that, while the income tax may burden disposable income freely, income that a taxpayer must devote to meeting the basic needs of the taxpayer and the taxpayer's family is exempt from

³⁴² BVerfGE 107, 27 at 52-3.

³⁴³ EStG §9, ¶1 Nr.4.

³⁴⁴ Basic Law Art. 6, Para. 1 provides: "[m]arriage and family shall be under the special protection of the state."

³⁴⁵ BVerfGE 107, 27 at 53.

³⁴⁶ BVerfGE 6, 55 (January 17, 1957), *infra* note 415 and accompanying text (prohibiting mandatory joint assessment of married individuals to produce a marriage penalty from a differential rate schedule).

³⁴⁷ BVerfGE 107, 27 at 56. The court also reserved judgment as to whether or not the durational limit might violate Basic Law Art. 12 para. 1 (protecting the individual's right to choose a profession freely) and Basic Law Art. 3 para 2 (guaranteeing equal rights without regard to sex).

³⁴⁸ *Supra* note 333 and accompanying text.

³⁴⁹ BVerfGE 82, 60 (May 29, 1990, 1st Senat) and BVerfGE 87, 153 (September 25, 1992, 2d Senat).

taxation. The leading case from a decade earlier than the dual household expense case required that the legislature exempt a subsistence minimum for each individual and family from the income tax.³⁵⁰ In the United States, by contrast, the general rule is that personal, living, or family expenses are not deductible, whether or not essential.³⁵¹ The legislature may choose to tax gross income and allows deductions only as a matter of its beneficence.³⁵²

The earlier of the decisions addresses the question whether the equality and family protection principles of the Basic Law require that measurement of income for income tax and social welfare program purposes be consistent with one another.³⁵³ The Constitutional Court acknowledged that the underlying policies that fix the tax and welfare structures may differ from one another and apply differing income measurements in order to achieve the policy goals of the laws.³⁵⁴ The social program involved in the case subsidized families with children with a direct payment per child – a child supplement. The cash subsidy complemented the exemption for children in the income tax law and provided families with additional resources.³⁵⁵ While all families with children received the subsidy, families with greater incomes received only the base amount subsidy while families with lower incomes received the base amount plus an additional subsidy.³⁵⁶ The statute that determined the amount of the subsidy measured income differently from the income tax law. Specifically, the subsidy statute determined the individual's subsidy amount by aggregating his positive income from the various income groups under the income tax law but, unlike the income tax law, permitted neither the loss from one income group to offset the income from other groups nor the losses of the individual's spouse to offset the individual's income.³⁵⁷

The individual challenging the statute before the Constitutional Court suffered a loss from his leasing activities. While the loss was deductible across income groups for income tax computations, it was not deductible in determining his income for purposes of fixing the child supplement.³⁵⁸ Accordingly, he received only the base amount of the

³⁵⁰ BVerfGE 87, 153 (September 25, 1992, 2d Senat). This Article discusses this decision in some detail *infra* commencing with the text accompany note 381.

³⁵¹ IRC §262. On the other hand, Congress exercised its “legislative grace” and allowed various deductions, including personal exemptions and a minimum standard deduction. IRC §63.

³⁵² The longstanding premise underlying tax deductions is: “[t]he power to tax income ... is plain and extends to the gross income. Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (U.S. 1934).

³⁵³ BVerfGE 82, 60 (May 29, 1990, 1st Senat).

³⁵⁴ BVerfGE 82 at 102.

³⁵⁵ The Constitutional Court addresses itself directly to the exemption for children in BVerfGE 82, 198 (June 12, 1990, 1st Senat), discussed in text commencing with note 376 *infra*.

³⁵⁶ *Id.* at 63.

³⁵⁷ The German income tax separates sources of income into seven groups and determines and combines the net income within each source group to form the tax base. EStG §2(1). With specific limits based upon the taxpayer's aggregate income, the taxpayer may deduct losses from one source group in whole or part against income from other source groups and may deduct his or her spouse's losses from the taxpayer's otherwise positive income in determining income subject to tax. EStG §2(3).

³⁵⁸ BVerfGE 82 at 65.

child supplement rather than the larger supplement he would have received with the diminished income. The Minister for Youth, Family and Health argued successfully that the reduction in the child supplement should be a function of economic income rather than taxable income. Taxable income, the Minister argued, takes various non-economic adjustments into account that the tax writers designed to provide tax subsidies having functions unrelated to ability to pay. Hence the child supplement rules for computing income approximate better true economic income and provide a better measure of need for the increased supplement than does taxable income. While the Minister conceded it is not possible to measure economic income under any set of rules perfectly, the child supplement rules are as or more reasonable than the income tax computation rules.³⁵⁹

The Constitutional Court accepted the Minister's line of argument and held that neither the equality principle,³⁶⁰ the protection of family principle,³⁶¹ nor the social state principle³⁶² required a uniform base for measurement of income under the child supplement and the income tax laws.³⁶³ The legislature correctly may factor out tax subsidies³⁶⁴ and losses from activities that the individual does not enter with a profit making intent³⁶⁵ in ascertaining the family's need for the increased child supplement. Disregarding true economic losses in the computation that prohibits offsetting losses from one income group against income in another group the court found would eliminate the formidable administrative task of separating economic from non-economic tax losses. Hence that imperfection that would fail to recognize some economic losses was also constitutionally permissible.³⁶⁶

In examining the structure of the child supplement, the court discovered that the supplement did not appear to be a fundamental element of the state's guarantee to each citizen of subsistence consistent with human dignity. The child supplement was independent of that subsistence minimum and was based on a far higher living standard than subsistence.³⁶⁷ Accordingly, the state could eliminate the child supplement if the legislature chose to do so. Similarly, the family protection principle permits but does not require the state to provide the family with any or a specific level of child supplement.³⁶⁸ And the court notes that the combination of the child supplement and the tax savings from exemption for dependent children generally is far less than the actual cost of supporting a child so that exemption amounts and child supplements seem to serve a purpose other than subsistence and are not subject to as strict scrutiny as subsistence guarantees might be.³⁶⁹

³⁵⁹ *Id.* at 72-3.

³⁶⁰ Basic Law Art 3 para. 1.

³⁶¹ Basic Law Art. 6 para. 1.

³⁶² Basic Law Art. 20 para 1.

³⁶³ BVerfGE 82 at 99.

³⁶⁴ *Id.*

³⁶⁵ *Id.* at 100-1.

³⁶⁶ *Id.* at 101.

³⁶⁷ *Id.* at 79-80

³⁶⁸ *Id.* at 81-2.

³⁶⁹ *Id.* at 95. But compare the decision in the subsistence exemption case discussed in the following commencing with the text accompanying note 381 *infra*.

In the course of its analysis of the income computation method for the child supplement, the court observed that taxing the subsistence minimum would diminish the taxpayer's resources to meet basic needs. That diminution, in turn, might compel the state to provide a direct subsidy to the taxpayer to guarantee the subsistence minimum.³⁷⁰ Given the choice between protecting the subsistence minimum from the income tax and requiring a state subsidy to increase the taxpayer's resources to the subsistence minimum, the court determines that exemption of the subsistence minimum from tax is the better choice. In addition, rather than taxing all income, but assuring the taxpayer a net income amount at least equal to the subsistence minimum, the court exempts the subsistence minimum amount from income taxation for all taxpayers in order to protect horizontal equity. Hence, the income tax must not tax that portion of the family's income equal to the subsistence minimum.³⁷¹ Any other approach would cause families with dependent children to be at a disadvantage relative to other families, assuming that income in excess of the subsistence minimum is disposable.³⁷² An example illustrates the court's reasoning:

Compare two families having equal amounts of disposable income, two adult members, one with a dependent child and one without, and a tax rate of 50%. Assume that the subsistence minimum for a two adult family is 10,000 and 5000 more for a dependent child. The first family has income of 30,000 and the second income of 25,000. A tax rate of 50% on all income leaves the first family with disposable income of zero ($30,000 \times .50 = 15,000$ tax payable in full and leaving the family with the subsistence minimum of 15,000 after tax) and the second family with disposable income of 2,500 ($25,000 \times .50 = 12,500$ tax from 25,000 leaves 2,500 disposable over the 10,000 subsistence minimum). If, on the other hand, only disposable income is taxable, each family is left with the same amount of disposable income – 7,500 (15,000 disposable subject to 7,500 tax at 50%).

The equality principle, in conjunction with the family protection principle, requires that tax law treat taxpayers with dependent children the same as taxpayers without dependent children, as expenses of raising children are expenses that diminish the individual's ability to pay tax as opposed to discretionary personal expenses that the tax law may disregard in assessing tax.³⁷³ Having defined ability to pay tax in terms of disposable

³⁷⁰ *Id.* at 85. The court in the dual household cases, BVerfGE 107, 27, *supra* note 314, expanded this minimum nontaxable amount to include essential family expenditures that diminish disposable income. This and the following discussion would seem unnecessary to the resolution of the case before the court and one would label the observations as *dicta* in U.S. legal analysis.

³⁷¹ *Id.* at 85-6 relying on the dignity principle of Basic Law Art 1, para 1, the social state principle of Basic Law Art 20 para 1 and the family protection principle of Basic Law Art 6 para 1. Here the court refers to the income tax (and possibly other direct taxes) only, as no exemption from the turnover tax exists for low-income families.

³⁷² *Id.* at 86.

³⁷³ *Id.* at 87. Referred to *supra* note 333 and accompanying text.

income, the court, without expressly so stating, concluded that horizontal equity demands equal treatment of taxpayers with like amounts of disposable income. Vertical equity does not support any other approach, so that the legislature must achieve progressivity through increasing rates of tax on increasing amounts of disposable income.³⁷⁴

Following its analysis in the child supplement case,³⁷⁵ the Constitutional Court directly addressed the adequacy of the income tax exemption amount for children in a decision the court released a couple of weeks later.³⁷⁶ Despite its holding in the earlier case that measurement of income for child supplement purposes could differ from measurement for income tax purposes, the court confirmed in this decision that a subsistence minimum encompassing all family members must remain free from the income tax.³⁷⁷ Adopting the methodology it applied in the child supplement case of converting the child supplement into an exemption equivalent and adding it to the exemption amount,³⁷⁸ the court held that the supplement and exemption combined for the years at issue failed to free the subsistence minimum from taxation.³⁷⁹ That failure violated the equality and family protection principles of the Basic Law.³⁸⁰

The relationship between the social welfare system and the income tax and the adequacy of its exemptions confronted the Constitutional Court again within a short period.³⁸¹ Taxpayers argued that the Basic Law required an income tax exempt amount for all taxpayers no lower than the subsistence minimum that social welfare established.³⁸² In order to determine whether the Basic Law required that level of exemption, the court traced the history of income tax law in Germany through its exempt amounts observing that “[t]he German income tax traditionally burdens only disposable income and frees receipts necessary to financing of basic needs ... from taxation.”³⁸³ The court identified the income tax exemption as a function of the relationship that the income tax bears to the indirect taxes, including the value added tax, by noting that freeing the subsistence minimum from the income tax “compensated for the heavy burden that indirect taxes imposed on poorer people.”³⁸⁴

³⁷⁴ *Id.* at 90.

³⁷⁵ BVerfGE 82, 60, discussed *supra* in text commencing at note 353.

³⁷⁶ BVerfGE 82, 198 (June 12, 1990, 1st Senat). The income tax exemption for children appeared in EStG §32 Abs 8 for the years at issue in the case. The exemption now is at EStG §32 (6).

³⁷⁷ *Id.* at 206-7.

³⁷⁸ BVerfGE 82, 60 at 83 and following.

³⁷⁹ BVerfGE 82, 198 at 208.

³⁸⁰ Art. 3 para. 1 and Art 6 para. 2 respectively.

³⁸¹ BVerfGE 87, 153 (September 25, 1992, II Senat), *supra* note 123.

³⁸² *Id.* at 159.

³⁸³ *Id.* at 155 (author’s translation). The original German reads: “Die deutsche Einkommensteuer belastet traditionell nur das verfügbare Einkommen und stellt die zur Finanzierung des existentiellen Bedarfs benötigten Einnahmen ... von der Besteuerung frei.”

³⁸⁴ *Id.* at 156 (author’s translation). The quote suggests that the subsistence minimum increases as indirect taxes increase. But while protecting the subsistence minimum as defined to encompass the cost of necessities including the turnover tax on the necessities, that exemption inures to the benefit of all taxpayers. The exemption tends to work against vertical equity by precluding nuances of progression among taxpayers with materially differing sums of “disposable” income. Compare statements in the legislative history to the earned income tax credit in the U.S., I.R.C. §32. Congress intended the earned

Following that historical structure, the court determined that personal freedom and free development of the individual's personality,³⁸⁵ both freedoms that taxation tends to restrict, require that each taxpayer be left with an amount after income tax that is not less than the subsistence minimum. At the same time, the court observed that a structure that exempts the subsistence minimum must not disregard the principle of vertical equity requiring progressivity in the income tax.³⁸⁶

While the subsistence minima social welfare fixes in providing subsidies to individuals do not necessarily constitute a perfect measure of subsistence, they provide a baseline below which the income tax may impose no burden.³⁸⁷ But as the social welfare system provides social assistance based upon local conditions, subsistence minima that social welfare administration establishes are only rough estimates of the minima. The federal legislature must exempt an amount from the income tax that will protect the subsistence minimum in as many instances as possible.³⁸⁸ In any event, statistics demonstrate to the court that existing exemptions fail to meet subsistence minima.³⁸⁹ The court also rejected the notion that specific exemptions not applicable to all taxpayers compensate for the inadequacy of the general exemptions.³⁹⁰

Mindful of the burden that requiring refunds might impose on the German treasury, the court chose to apply its decision with respect to subsistence minima and the income tax prospectively.³⁹¹ Social welfare assistance would be available to taxpayers whom the income tax might leave with insufficient resources to meet their subsistence needs.³⁹² Despite prospective application, the Constitutional Court firmly established an income tax exemption zone around the subsistence minimum and looked to the social

income credit to enable low-income families to meet the rising cost of living and to offset partially the regressive effect of the social security tax on employed low-income individuals. HR 2166, HR Report 94-19 at 10 (94th Cong. 1st Sess, Feb. 25, 1975) and more directly, S.Rep. 94-36 (94th Cong. 1st Sess, March 17, 1975) at 11 that reads in part: "[t]he credit is set at 10 percent in order to correspond roughly to the added burdens placed on workers by both the employee and employer social security contributions." The Senate report suggests that Senate taxwriters believed that the employee bore the burden of both the employer's and the employee's share of social security taxes. Unlike the subsistence minimum exemption in Germany, the earned income credit phases out as taxpayers' incomes increase.

³⁸⁵ *Id.* at 169 citing Basic Law Art. 2 para. 1.

³⁸⁶ *Id.* at 170, citing with approval BVerfGE 82, 60, 89, discussed in detail *supra* notes 370-374 and accompanying text.

³⁸⁷ *Id.* at 170-71.

³⁸⁸ *Id.* at 172.

³⁸⁹ *Id.* at 174-5.

³⁹⁰ *Id.* at 176.

³⁹¹ *Id.* at 178. Note that taxpayers who, two years earlier, successfully argued that the exemptions for children were inadequate to meet the subsistence minimum received relief in BVerfGE 82, 198, discussed *supra* beginning with note 376.

³⁹² *Id.* at 180.

welfare system to define that minimum,³⁹³ including the effect of indirect taxes on the individual.³⁹⁴

In late 1998, the Constitutional Court traced a more detailed methodology for determining the amount of the tax-free subsistence minimum for children.³⁹⁵ The court specified that while the social welfare amount generally would continue to provide the floor for the minimum, certain departures from social welfare computational methods were permissible. For example, with respect to incremental housing needs for an additional child, social welfare used a per capita computation, but the court accepted an incremental need standard that takes into account that no additional common area space (kitchens, bathrooms) is necessary when the family adds a child.³⁹⁶ While accepting a shortfall tolerance of as much as 15 percent of the subsistence minimum for a child between the tax exemption and social welfare amounts, that tolerance would diminish if the computation for tax purposes rejects social welfare's questionable computational conventions such as per capita.³⁹⁷

The court required that the subsistence minimum remain free of income tax at all income levels and marginal rates of tax.³⁹⁸ As Germany provided a child supplement for each child, as well as an income tax exemption for each child, conversion of the child supplement into its exemption equivalence became necessary to ascertain whether the combination of the supplement and the exemption together left the subsistence minimum per child exempt from taxation.³⁹⁹ Conversion of the child supplement into a deduction equivalent must operate at each taxpayer's maximum marginal tax rate, lest taxpayers with children bear a disproportional tax burden relative to taxpayers without children or to taxpayers in higher marginal brackets exempt from tax on the full family subsistence minimum.⁴⁰⁰ For the tax year in question, one child, taxpaying families with marginal

³⁹³ *Id.* at 171.

³⁹⁴ *Supra* note 384 and accompanying text. As subsistence minima relate in part to the burden of indirect taxes that each individual bears, those minima must include indirect taxes and eliminate the regressivity of the indirect taxes through either direct welfare payments that guarantee human dignity (including payment of indirect taxes) or exemption from the income tax of amounts necessary to meet the minima including the indirect taxes.

³⁹⁵ BVerfGE 99, 246 (November 10, 1998, 2d Senat). This decision is one of three the Constitutional Court issued on the same day addressing the same issue but for different taxpayers and taxable years. The other cases are BVerfGE 99, 268 (November 10, 1998, 2^d Senat) and BVerfGE 99, 273 (November 10, 1998, 2^d Senat).

³⁹⁶ *Id.* at 263.

³⁹⁷ *Id.*

³⁹⁸ *Id.* at 264-5.

³⁹⁹ *Id.* at 265. See *supra* note 378 and accompanying text.

⁴⁰⁰ *Id.* The computational intricacy of this concept is important. The court's underlying fairness principle is that progressive rates commence for all taxpayers at the same point: income in excess of the subsistence minimum for the family. The subsistence minimum is exempt from income tax. See the example in the text following note 372 *supra*. Like any deduction, the subsistence minimum exemption is more valuable for taxpayers subject to higher maximum rates of tax than taxpayers subject to lower maximum rates, since deductions reduce tax at the margin. As the Constitutional Court views the subsistence minimum as an exemption from tax, consistency demands that, in evaluating a direct subsidy like the child supplement as satisfying part of that subsistence exemption, it must convert the subsidy into its exemption equivalent amount. That means that the court must take tax rates in account. Accordingly, it requires a larger subsidy

rates of 40% or more do not enjoy a full subsistence exemption.⁴⁰¹ While the Constitutional Court left the Federal Financial Court to fashion the appropriate form of remedy, the Constitutional Court was unwilling to apply its holding prospectively only,⁴⁰² as it had done in the earlier subsistence case.⁴⁰³

The Constitutional Court has shown itself to tolerate legislative and administrative imprecision in application of the equality principle as needed to allow for generalized approaches to taxation. For example, the court allowed a generalized approach to the deduction for home office expenditures.⁴⁰⁴ The statute on home office expenditures distinguished among home offices used 50 percent or less for business for which there was no deduction; home offices used more than 50 percent for business but that were not the center of the taxpayer's business activity for which the statute limited the deduction to a specific amount; and home offices used exclusively as the center of the taxpayer's business activity for which all expense were deductible.⁴⁰⁵ The taxpayer argued that the statute allowed the full cost of an outside office and placed home offices at a disadvantage. The court, however, accepted the need to generalize in the law and permitted the statute to stand, even though it might result in some home office users being placed at a disadvantage.⁴⁰⁶

Nevertheless, the legislative wish to generalize and categorize may not conflict with the equality principle in conjunction with the protection of family principle.⁴⁰⁷ Confronted with possible disparate treatment of families relative to one another or families without children, recent decisions affirm both the Constitutional Court's commitment to a family subsistence minimum free from income taxation and a level playing field for all taxpayers without regard to family status.⁴⁰⁸

for higher rate individuals to convert into the same exemption amount for lower rate individuals. Hence a €1000 subsidy to a 20% bracket taxpayer is the same as a €5000 exemption, but only a €2500 exemption to a 40% bracket taxpayer. So a €2000 exemption is needed for the 40% bracket taxpayer to protect the same subsistence minimum of €5000. If that outcome seems rather peculiar since a direct subsidy covers the same amount of expenses for each family, it is nevertheless inherent in defining the subsistence minimum as an exemption rather than providing a refundable credit against tax to all taxpayers in an amount equal to the subsistence minimum. To a limited extent Germany does just that by providing welfare assistance to individuals whose incomes are less than the subsistence minimum. See the Bundessozialhilfegesetz (Federal Social Welfare Law) (June 30, 1961, version of March 23, 1994, as amended through November 25, 2003).

⁴⁰¹ *Id.* at 266.

⁴⁰² *Id.* at 267-8.

⁴⁰³ *Supra* note 391 and accompanying text.

⁴⁰⁴ BVerfGE 101, 297 (July 12, 1999, 2d Senat).

⁴⁰⁵ EStG §4 (5) 6b. Compare the U.S. restrictions on home office deductions in IRC § 280A.

⁴⁰⁶ BVerfGE 101, *supra* note 404, at 310.

⁴⁰⁷ Basic Law Art. 6.

⁴⁰⁸ BVerfGE 102, 127 (May 24, 2000, 1st Senat), BVerfGE , , 2 BvR 167/02 (January 11, 2005, 2d Senat) (available at: http://www.bverfg.de/entscheidungen/rs20050111_2bvr016702.html), BVerfGE , , 2 BvL 7/00 (March 16, 2005) (available at: http://www.bverfg.de/entscheidungen/lis20050316_2bvl000700.html), cases discussed in text following this note.

In the first of these cases,⁴⁰⁹ the taxpayer could not claim the child exemption and did not receive the child supplement for her adult child because the child, who otherwise met the requirements for a continuing exemption and supplement, earned income in excess of the statutory limit. Under a statutory “cliff” loss of benefits provision in both the income tax law and the social security law, as soon as a child’s income exceeded a fixed sum, the benefits were lost. The taxpayer argued both that the loss of benefits provision was unfair because it did not provide for any phased structure and that the computational structure in the case of her child was unfair. The court reached the second but not the first argument in finding for the taxpayer. Unlike customary employment relationships in Germany that require the employer to reduce the employee’s compensation by the employee’s share of social insurance payments, that withholding-type rule did not apply to the child’s employment relationship. Accordingly, the child’s employer did not withhold. Specifically, the child’s employer was not required to reduce the child’s income by the amount of social security contributions, as permitted for the specific employment relationship. Even though the child had to make the payments in any event, the child’s income was measured for loss of benefits on a pre-social insurance contribution basis. Other employment relationships deducted social insurance payments from income first, so that other children with comparable gross incomes measured their incomes for loss of benefit purposes on an after social insurance payments basis. Accordingly, the income measurement affected the taxpayer’s child adversely relative to similarly situated individuals with comparable incomes. The Constitutional Court held that the equality principle required consistent measurement of income for all taxpayers, so that the taxpayer’s child, so viewed, received income that was less than the loss of benefits amount. The court noted that it need not answer the other argument in this case because the income measurement issued controlled the outcome for the taxpayer.

In the second of the two decisions,⁴¹⁰ the Constitutional Court turned its attention to childcare expenditures that are deductible as costs of income production.⁴¹¹ The income tax provision allowing the childcare deduction placed both a floor and a ceiling on the deductible amount. Although the taxpayer did not challenge the ceiling, the court commented that the ceiling seemed a reasonable accommodation to control excessive expenditures that were in fact discretionary, rather than necessary, to facilitate parental employment or training. The floor during the year at issue was an imputed sum based upon the taxpayer’s filing status and income.⁴¹² Only expenditures in excess of that imputed amount were deductible. The court observed that the statute placed parents with childcare expenses at a disadvantage relative to individuals with no children. Since childcare expenditures were not discretionary but mandatory for working parents, the floor rendered some portion of childcare expenses non-deductible. The floor resulted in income taxation of non-disposable income, and diminution of the income tax free family subsistence minimum in violation of equality principle combined with the protection of

⁴⁰⁹ BVerfGE , , 2 BvR 167/02.

⁴¹⁰ BVerfGE , , 2 BvL 7/00, supra note 408 (March 16, 2005).

⁴¹¹ EStG § 33c (allowing the deduction for parents who are working or attending school or training). Compare the limited tax credit under U.S. law, I.R.C. §21.

⁴¹² Under the current statute, the floor is a fixed sum per child.

family principle.⁴¹³ The court emphasized that the principle of horizontal equity in taxation, especially as it might affect decisions whether or not to have children, was particularly robust.⁴¹⁴

B. Marriage Penalties. Relatively early in the post-war period, the Constitutional Court addressed a challenge to the mandatory joint assessment of married individuals under the income tax.⁴¹⁵ Rate brackets in effect for 1951, the tax year at issue in the case, applicable to jointly assessed couples were somewhat broader at lower incomes than individual brackets, but not twice individual brackets.⁴¹⁶ The rate structure did benefit some couples. If the couple had a principal income earning spouse and the other spouse earned a small amount of income or no income, joint assessment was beneficial to the couple as the joint brackets would free a larger amount of income from tax than would separate filing at individual rates.⁴¹⁷ Where both spouses earned substantial income or comparable amounts of income, separate assessment at individual rates would result in a smaller tax burden for the marital unit than would joint assessment.⁴¹⁸

While the statute nominally required joint assessment for all spouses who lived together for four months or more during the assessment period,⁴¹⁹ the implementing regulation excluded from the joint assessment base, income that the wife earned from employment (rather than self-employment) so long as the husband was not her employer.⁴²⁰ The regulation places the sub-classification of self-employed, married women at a disadvantage relative to employed married women as well as both employed and self-employed married men. The Constitutional Court easily could have decided the

⁴¹³ Compare the discussion of the two residence household, *supra* in text accompanying and following note 331.

⁴¹⁴ 2 BvL 7/00, *supra* note 408, at ¶45-6.

⁴¹⁵ BVerfGE 6, 55 (January 17, 1957).

⁴¹⁶ Under section 32 of the income tax law of 1951 (Einkommensteuergesetz 1951 in the version from January 17, 1952), married couples were in tax class II, individuals with children in class III and other taxpayers in class I. Additional exempt amounts applied to classes II and III and the tax tables imposed a smaller tax on the incomes of taxpayers of up to 5000 German Marks who were in classes II and III than the tables imposed on class I taxpayers. Moreover, one spouse's losses offset the other spouse's income. Under current law, the brackets are effectively twice the individual brackets. EStG §32a (5) assesses a spouse on half the marital unit's income at individual rates and doubles the amount of tax computed in that manner. U.S. law with its separate rate schedules for individual and married taxpayers continues to resemble the earlier German model, the joint filing brackets are broader than unmarried individual bracket but not twice as broad, and married filing separately brackets are half the breadth of the joint brackets. IRC §1(a), (c), (d). Note, however, that IRC §1(f)(8) makes the joint filing brackets equal to twice the single individual brackets for the 15% bracket for the 2003 and 2004 tax years and again for 2008 through 2010 with smaller sizes for the intermediate years.

⁴¹⁷ For example, a single earner family with income of 5000 German Marks drew a tax 652 Marks in Class II while a Class I taxpayer would have paid 810 Marks. Einkommensteuergesetz 1951 Table B.

⁴¹⁸ If married taxpayers each had income of 2500 Marks (total 5000), each would pay 235 Marks for a total tax of 470 Marks if they were separate Class I taxpayers, but 652 Marks on the combined income as Class II taxpayers. Einkommensteuergesetz 1951 Table B.

⁴¹⁹ *Id.* at 56. Einkommensteuergesetz 1951 §26.

⁴²⁰ Section 43 of the implementing regulation to the income tax law (Einkommensteuer-Durchführungsverordnung in the version of January 17, 1952) §43.

case on narrow equality principle grounds as discriminatory against the sub-class. Instead the court chose not to address that discrimination as its decisional basis.⁴²¹

After disposing of the procedural limitation that pre-constitutional law might impose on the Constitutional Court's jurisdiction,⁴²² the court traced the rather interesting history of the rather peculiar selection of self-employed, married women for mandatory joint assessment on their earnings.⁴²³ Early tax laws in Prussia assessed family income as a unit and later freed certain household members from common assessment. Legislation from 1921 separated the wife's income from services from her income from other sources and permitted separate assessment of that service income. During the period that the National Socialist controlled the German government, the government included the wife's income from services again in the joint assessment. According to the secretary of finance at that time, the goal of the inclusion was for the political purpose of forcing women out of the labor market. The subsequent exception for income from services as an employee became necessary, as the war demanded that women return to the work force to support the war effort.⁴²⁴

The Constitutional Court examined the protection of marriage principle that the Basic Law includes⁴²⁵ and rejected mandatory joint assessment in so far as it burdened rather than benefited marriage.⁴²⁶ Arguments in favor of joint assessment were that the mandatory joint assessment was permissible to educate spouses and to shape the marital relationship in the best interests of the family and the state. The court firmly rejected both arguments on protection of marriage and sexual equality grounds.⁴²⁷ Interpretation of the protection of marriage principle must be consistent with other constitutional protections.⁴²⁸ Equal rights means that the spouses always must remain free to select the structure of the relationship without any economic pressure from the state, in the form of an increased tax burden, to choose one earner rather than two earner household status. Thus, the Constitutional Court left no opening for modification of the joint assessment that would impose a greater tax burden on a married couple than on two unmarried individuals.⁴²⁹

⁴²¹ BVerfGE 6 at 83 raising the Basic Law Art. 3 issues within the group of married individuals but not relying on them for the decision.

⁴²² *Id.* at 64.

⁴²³ *Id.* at 67.

⁴²⁴ *Id.* at 65-66. Perhaps the recitation of the history and its link to the national socialists compelled the court to conclude that the joint assessment was unconstitutional, as one cannot imagine that the court would subscribe to a rationale emanating from the politics of that regime.

⁴²⁵ Art 6, para. 1.

⁴²⁶ Such an increased tax burden on the spouses that attaches to the conclusion of marriage ... is inconsistent with Art. 6, para. 1 of the Basic Law. BVerfGE 6 at 70. (Author's translation).

⁴²⁷ *Id.* at 82 relying on Art. 3, para. 2 in addition to Art. 6.

⁴²⁸ *Id.*

⁴²⁹ Spouses may elect joint or separate assessment under current law. EStG §26 (1). As the tax is measured as if each spouse received half the income, joint assessment is advantageous for single earner marital units and two earner units in which one spouse, if assessed separately, would not pay tax at the margin at the maximum rate. For other units, joint assessment produces the same tax liability as separate assessment would.

Similarly, the Constitutional Court ruled that the disallowance of a deduction for salary paid to one's spouse in computing one's liability for the municipal business tax⁴³⁰ was unconstitutional⁴³¹ as it likewise violated both the equality principle⁴³² and the protection of marriage provision.⁴³³ Although the income tax permitted a deduction for salary paid to one's spouse, the municipal business tax at issue in the case denied the deduction. The legislative reasoning for denying the deduction was to protect the tax base. As business owners could not deduct payments to themselves because such payments would undercut the tax base, they should not be able to undercut the base by hiring their spouses – a seemingly transparent way to avoid the deduction limit for the salary of the business proprietor. Despite this rationale, the Constitutional Court saw the disallowance as favoring non-spousal employees over spousal employees in violation of equality principles and as a tax burden on marriage. The limitation on deductibility would not arise if the individuals lived together but did not marry.

Following the Constitutional Court's decision prohibiting mandatory joint assessment of married couples,⁴³⁴ the German legislature revised the income tax law to permit, but not require, married taxpayers to elect joint assessment.⁴³⁵ Married couples who elect joint assessment combine their incomes, determine the tax for an individual on one-half that combined income and double the amount of tax.⁴³⁶ While joint assessment and income splitting is beneficial to taxpayers for whom it moderates tax progression, joint assessment will never result in a greater tax than the combined tax the couple would pay on their separately assessed incomes.⁴³⁷

Elective joint assessment for married couples was not without controversy. Single taxpayers with dependent children argued that they too should enjoy the tax benefit of income splitting because of the cost of caring for children.⁴³⁸ While acknowledging that a married couple without children enjoyed a more favorable tax position through income splitting than unmarried individuals with dependent children, the Constitutional Court was unwilling to find fault with income splitting.⁴³⁹ Instead, the Constitutional Court determined that splitting was not a tax subsidy but rather enabled couples to structure their economic arrangements within the marriage without concern for the tax impact of the choice.⁴⁴⁰ Essentially, splitting assigns value to one spouse's work at home caring for the household and children equal to that of the other spouse's work for

⁴³⁰ Gewerbesteuer probably translates better as a business enterprise tax but as municipal governments impose the tax, common translation is as above.

⁴³¹ BVerfGE 13, 290 (Jan. 24, 1961).

⁴³² Art 3 of the Basic Law.

⁴³³ Art 6.

⁴³⁴ BVerfGE 6, 55, *supra* note 415. See discussion in text accompany and following the cited note.

⁴³⁵ EStG §26. In the absence of an election, joint assessment is presumptive under EStG §26(3).

⁴³⁶ The German tax law refers to the method as income splitting. EStG §32a (5).

⁴³⁷ BVerfGE 108, 351, 355 (1st Senat, Oct. 7, 2003).

⁴³⁸ BVerfGE 61, 319 (March 11, 1982)

⁴³⁹ *Id.* at 351.

⁴⁴⁰ *Id.* at 345-6.

compensation,⁴⁴¹ consistent with the equal rights⁴⁴² and marriage protection provisions of the Basic Law.⁴⁴³ As to the single parent issue, the court acknowledged the validity of the claim on other grounds and viewed the issue in the similar light to its subsistence minima decisions.⁴⁴⁴ Holding that the deductions and exemptions available to single individuals with dependent children were inadequate to free the basic costs of caring for children from taxation,⁴⁴⁵ the court directed the legislature to eliminate the problem but left to the legislature the task of formulating the necessary remedy.⁴⁴⁶

More recently, the Constitutional Court reviewed the interplay of income splitting and maintenance obligations to a former spouse following divorce.⁴⁴⁷ The amount of maintenance payable to a former spouse who cannot support herself⁴⁴⁸ is a function of the marital standard of living that preceded the divorce (taking in account likely changes that already had affected the marital standard before the divorce).⁴⁴⁹ In turn, standard of living is a function of available resources and takes taxes payable into account. To the extent that the couple elected and derived a benefit from joint assessment and income splitting before divorce,⁴⁵⁰ the divorce terminates availability of the election. After divorce, a limited form of actual income splitting becomes available. A former spouse paying maintenance may deduct some or all of the maintenance payments so long as the recipient consents to including the maintenance payment in her income.⁴⁵¹ Loss of the more general income splitting election may increase the payer's income tax and diminish resources available to him with which to pay maintenance. The divorce court must take that diminution of resources into account in fixing the maintenance obligation.

⁴⁴¹ *Id.* at 346. And see Tipke/Lang, *supra* note 51, at 122. Note, however, that the court does not address the imputed, but untaxed income, that the spouse working at home generates. Neither Germany nor the U.S. taxes imputed income from labor for one's immediate family and does not even take cost savings from avoiding the cost of payment to a third party for housework into account. See, generally, Nancy C. Staudt, Taxing Housework, 84 GEO. L.J. 1571 (1996) (arguing that failure to tax housework forces many women into the labor market to find a value and appropriate compensation for their labor).

⁴⁴² Basic Law Art. 3 para. 1

⁴⁴³ Basic Law Art. 6 para. 1.

⁴⁴⁴ Discussed *supra* in Part IV.A.

⁴⁴⁵ BVerfGE 61, *supra* note 438, at 353-4.

⁴⁴⁶ BVerfGE 61, *supra* note 438, at 354.

⁴⁴⁷ BVerfGE 108, 351, *supra* note 437.

⁴⁴⁸ Statistically far more women in Germany and the U.S. receive maintenance or alimony than men, hence the selection of a feminine pronoun for the recipient of maintenance.

⁴⁴⁹ BVerfGE 108, 351, *supra* note 437, at 353 citing the Civil Code (das Bundesgesetzbuch) § 1578 para. 1, sentence 1.

⁴⁵⁰ EStG §§26, 32a (5).

⁴⁵¹ EStG §10 (1) 1. Under current law, the payer's deduction may not exceed €13,805 per annum. EStG §22 1a includes the maintenance payment in the recipient's income only to the extent of the payer's deduction. According to the Constitutional Court, the payer must indemnify the recipient who consents to the inclusion in her income from the tax cost of the inclusion. BVerfGE 108, 351, *supra* note 437 at 356. The indemnification is not a statutory requirement but the result a fair exchange of consent for the indemnity as confirmed in case law. See PALANDT BÜRGERLICHES GESETZBUCH (Civil Code) 1489 (Munich 1999). U.S. law provides similarly for actual income splitting through alimony (without a ceiling on the deduction and inclusion) under I.R.C. §§71, 215. The payer's deduction is an adjustment to gross income under I.R.C. §62(a)(10), and not an itemized deduction under I.R.C. §63, so that the deduction provides a tax benefit to the payer even if the payer does not itemize his deductions.

When the individual who is obligated to pay maintenance remarries, the new marriage entitles the spouses to elect joint assessment and income splitting.⁴⁵² Income splitting in the new marriage may decrease the maintenance paying individual's tax burden and increase his economic resources accordingly.⁴⁵³ In the combined cases before the Constitutional Court,⁴⁵⁴ divorced spouses receiving maintenance payments in such remarriage situations successfully claimed in the lower courts that the protection of marriage principle entitled them to share in the increased resources that the new income splitting election generated.⁴⁵⁵ The Constitutional Court ruled, however, that the income splitting opportunity belonged to the new marriage, so that, that protection of marriage principle required that any increased resources remain with the new marriage.⁴⁵⁶

C. Assessment, Collection and the Equality Principle. Perhaps the most radically, far-reaching of the Constitutional Court's tax decisions is its recent securities speculation case.⁴⁵⁷ In that decision the court held that the equality principle⁴⁵⁸ precluded assessment and collection of the tax on speculation profits from trading in securities because most taxpayers easily evade that tax. Thus, the structural deficiency in execution of the tax law⁴⁵⁹ rendered the application of the tax law to honest taxpayers unfair.⁴⁶⁰

Unlike the possible constitutional barrier to taxing unrealized gains in the United States,⁴⁶¹ there is no constitutional barrier to taxation of capital gain in Germany.⁴⁶² However, Germany did not (and does not) treat individuals' capital gains as income,⁴⁶³ except the gains from speculation in securities having a holding period in the taxpayer's hands of not more than six months.⁴⁶⁴ The statute sought to tax those gains that might result from the conduct of trading activity, rather than simple capital appreciation while

⁴⁵² EStG §§26, 32a (5).

⁴⁵³ In the instances before the Constitutional Court, the increase in resources was a function of the applicable tax table to use for the wage tax (Lohnsteuer), a tax collection method that is similar to wage withholding in the U.S. I.R.C. §3401 et. seq.

⁴⁵⁴ BVerfGE 108, 351, *supra* note 437.

⁴⁵⁵ *Id.* at 352, one case comes from the state appellate court in Brunswick (Oberlandesgericht Braunschweig) and the other from the state appellate court in Stuttgart (Oberlandesgericht Stuttgart).

⁴⁵⁶ *Id.* at 369.

⁴⁵⁷ BVerfGE 110, 94 (March 9, 2004, 2d Senate), *supra* note 30.

⁴⁵⁸ Basic Law 3(1).

⁴⁵⁹ In German: ein strukturelles Vollzugsdefizit (author's translation).

⁴⁶⁰ Compare the U.S. exemption of the capital gains of non-resident aliens and foreign entities not engaged in a U.S. trade or business. I.R.C. §§871(a) and 881(a) do not include capital gain in the income that is subject to withholding. Congress exempted capital gains because it was impractical to collect tax on the gain. See *Rohmer v. Commissioner*, 153 F.2d 61, 64 (2d Cir. 1946), cert. denied, 328 U.S. 862 (1946) (permitting taxation of royalties under the predecessor to I.R.C. §871 and discussing legislative history of inability to tax capital gains).

⁴⁶¹ *Eisner v. Macomber*, *supra* note 12, discussed in note 169 and accompanying text.

⁴⁶² BVerfGE 26, 302, 312 (July 9, 1969, 2d Sen.).

⁴⁶³ See, *supra* note 93 and accompanying text.

⁴⁶⁴ BVerfGE 110, 94, 95-6 quoting in part §23 of the Income Tax Law as in effect in 1998 referring to speculation activities. Under current law, the provision refers to private sale activities and encompasses securities the taxpayer has held for no more than one year. EStG §23(1) 2. Compare short term capital gain under I.R.C. §1222(1).

enjoying a possible income benefit from the investment through dividend or interest income.⁴⁶⁵

The statute, however, did not provide for a withholding tax on those gains⁴⁶⁶ or informational reporting by third party intermediaries.⁴⁶⁷ The taxing agency lacked authority to go on a fishing expedition⁴⁶⁸ into private and third party records, and privacy rights prevented banking and other third parties from providing information on transactions to the taxing authorities in the absence of an express and specific reporting obligation. Moreover, during the years at issue, the tax authorities made no meaningful effort to identify short term trading profits from securities through regular audit activities. Hence there was little threat of detection to encourage taxpayers to report honestly.⁴⁶⁹ While the statute imposed a reporting obligation on taxpayers, the Constitutional Court observed that the tax would act as a penalty for honest taxpayers who reported their activities but generally would fail to reach taxpayers who failed to report.⁴⁷⁰ In effect but not in form, the statute imposed a greater tax burden on honest taxpayers than it did on dishonest taxpayers and so violated the equality principle.⁴⁷¹

The Constitutional Court expressly limited its decision to the trading of securities in the taxable years 1997 and 1998.⁴⁷² As the essence of the decision is lack of and barriers to enforcement rendering assessment and collection from honest taxpayers a violation of horizontal equity principles, the decision might extend to other activities, including independent personal services. The court seeks to anticipate and prevent those arguments by identifying differences in assessment and collection for other activities. For short term dealing in real estate that the same statute governs,⁴⁷³ as opposed to holding real estate for income production or personal use, the court noted that information reporting prevented the level of tax evasion present with respect to securities

⁴⁶⁵ *Id.* at 98. The Constitutional Court cites decisions of the Federal Financial Court to explain that the statute in question, EStG §23, in the case of land speculation, sought to distinguish those taxpayers who held land in order to derive income from operation or farming of the land from those taxpayers who primarily speculated in the value of the land itself by buying and selling land over relatively short holding periods.

⁴⁶⁶ EStG §38 (employer withholding of wage tax); §43, 44 (entity withholding on dividends, creditor withholding on interest).

⁴⁶⁷ Germany lacks the extensive array of information reporting that Ch. 61, Subch. A, Part III, I.R.C. §6031 et seq., requires of U.S. persons. See discussion in Roman Seer, Besteuerungsverfahren, *supra* note 60 at 62-63 and 128 (Tabelle 15, Kontrollmitteilungspflichten).

⁴⁶⁸ Colloquial (author's translation of the equally colloquial 'ins Blaue hinein' that the court uses at BVerfGE 110, 94, 115.

⁴⁶⁹ *Id.* at 114-15.

⁴⁷⁰ *Id.* at 104. Compare BVerfGE 84, 239 (June 27, 1991) (holding for similar reasons that taxation of interest income was unconstitutional but delaying application of the decision to give the tax authorities time to equalize collection of the tax).

⁴⁷¹ As the court relies on the indirect evidence from market conditions yielding considerable profits without offsetting losses during the years at issue to support its conclusion of unequal tax burdens, the court reserves judgment as to any unconstitutional impact of enforcement of the statute in years after 1998 when market losses may have offset the market gains. *Id.* at 140-1.

⁴⁷² *Id.* at 111.

⁴⁷³ EStG §23(1).

trading.⁴⁷⁴ Transfers of land require participation of a notary,⁴⁷⁵ has a reporting obligation for tax on real property acquisition.⁴⁷⁶ With respect to leasing activities, the income from which taxpayers might not report, the court notes that taxpayers generally hold the property for extensive periods and have an incentive to report income because they will wish to deduct their losses from the activity.⁴⁷⁷

In other areas where Germany has a serious problem with the underreporting of income, the court finds that the taxing authority's collection efforts differ materially from those for short term securities trading. For example, the Constitutional Court anticipates and dismisses the possible argument of taxpayers, who are not employees and, therefore, not subject to the withholding mechanisms of the wage tax. Those taxpayers might argue that the underreporting problem in the underground economy⁴⁷⁸ causes the taxation of the income from the services of honest taxpayers who do report unfair because their tax burden exceeds that of dishonest taxpayers who the tax system cannot identify and control.⁴⁷⁹ Thus they might argue that taxation of independent service income then similarly would violate the equality principle, that is, "the constitutional requirement of actual identical taxation burden through identical law enforcement"⁴⁸⁰ would be lacking. To that argument, the Constitutional Court observes that unconditional tax audits for such income, as contrasted with the dearth of audit activity for short term securities trading, pose more than an incidental risk of discovery for the underreporting taxpayer. Thus, unlike securities trading, the assessment system does not invite under- or non-reporting of income from services.⁴⁸¹ Similarly, the taxing authorities programmatically and actively seek to discover offshore investment in order to tax income from that capital.⁴⁸²

D. Retroactivity. An early series of three decisions established the principle that a rate increase during a tax year may apply to the whole year⁴⁸³ but that a rate increase may

⁴⁷⁴ BVerfGE 110, 94 at 132.

⁴⁷⁵ Civil law legal systems assign a major role to notaries who prepare transfer documents and handle many of the tasks that attorneys carry out in the United States.

⁴⁷⁶ Grunderwerbsteuergesetz §18.

⁴⁷⁷ BVerfGE 110, 94 at 132.

⁴⁷⁸ Schattenwirtschaft (shadow economy).

⁴⁷⁹⁴⁷⁹ Like the U.S., Germany has a substantial segment of its economy that escapes taxation because service providers receive payments in cash that the service recipient does not report. The German term for such work is *Schwarzarbeit* (black work or black market work) and was estimated to represent some 16 percent of Germany's gross domestic product in 2001, increasing gradually from 12% in 1990. Annette Mummert and Friedrich Schneider, 58 *FinanzArchiv* 286 (2001), estimated to be 643 billion German Marks in 2001 (€ 329 billion). *Id.* Note, however, that insofar as the unreported income in Germany involves low wage workers, as it does in the U.S., those workers would not pay income tax in any event because of the subsistence minimum that is exempt from income tax. The unreported income becomes subject to the turnover tax just as fully reported income does when the workers consume goods and services, so there is no loss of revenue that the government otherwise would collect. See discussion of the relationship between the turnover tax and the subsistence minimum exemption *supra* in Part 2. Hence the revenue loss with such work primarily is a function of taxes and mandatory contributions for social welfare.

⁴⁸⁰ Translating BVerfGE 110, 94 at 112: "das verfassungsrechtliche Gebot tatsächlich gleicher Steuerbelastung durch gleichen Gesetzesvollzug"

⁴⁸¹ BVerfGE 110, 94 at 133.

⁴⁸² *Id.* at 133-34.

⁴⁸³ BVerfGE 13, 274 (December 19, 1961, 2d Senate).

not apply to a closed year⁴⁸⁴ unless taxpayers reasonably anticipate that an unset rate must become fixed.⁴⁸⁵ The outcome of the first cited case matches the result in the United States.⁴⁸⁶ But the strict limitation that the second case imposes to limit retroactivity to the current year does not apply in the United States when the change is a rate or base change, rather than the imposition of a new tax.⁴⁸⁷ The German cases rely on the rule of law principle emanating from the constitutional definition of Germany as “a democratic and social federal state.”⁴⁸⁸ The principle requires that citizens have the opportunity to know what the law is so that they may conform their behavior and modify their transactions to use the law most effectively.

E. Value Dependent Taxes and the Equality Principle. The Constitutional Court held both wealth tax⁴⁸⁹ and the inheritance tax⁴⁹⁰ to be inconsistent with the equality principle.⁴⁹¹ Both the wealth tax law and the inheritance tax law used the valuation standards and methods that the valuation law provided.⁴⁹² Other than rental real property and real property used as part of a business for which capitalization of earnings provided the value, fixed values applied to real property under the valuation law. The fixed values were 1964 assessment values multiplied by 1.4. Since securities were valued at market and productive property at capitalization of earnings or, in the case of property not in production, but productive, capitalization of estimated earnings as productive, the values of those properties were reasonably up to date. Real property, on the other hand, tended to be undervalued substantially, as the overall real estate market had advanced considerably since 1964. Applying the same rate of tax to real estate as to other property meant that taxpayers whose wealth or inheritance concentrated itself in real estate paid disproportionately lower taxes than taxpayers who owned or received other property. That disparity violated the equality principle and rendered both statutes unconstitutional.⁴⁹³

⁴⁸⁴ BVerfGE 13, 261 (Dec. 19, 1961, 2d Senate).

⁴⁸⁵ BVerfGE 13, 279 (December 19, 1961, 2d Senate). however in this case the rate was set nine months into the year, so that the earlier cases might have sufficed to decide this case as well.

⁴⁸⁶ *Darusmont v. United States*, *supra* note 153.

⁴⁸⁷ *Wilgard Realty Co. v. Commissioner*, 127 F2d 514 (CA2, 1942), cert. denied 317 US 655 (1942). Debate concerning this issue of retroactivity continues in the US. See articles cited *supra* note 153. Congress often announces effective dates in advance of enactment so that taxpayers are on notice of pending, retroactive changes.

⁴⁸⁸ Art 20 of the Basic Law generates the *Rechtstaatprinzip*.

⁴⁸⁹ BVerfGE 93, 121, *supra* note 28, (June 22, 1995). The Wealth Tax Law of 1974 (*Vermögensteuergesetz*), (in the version of November 14, 1990, most recently amended by the law of September 14, 1994) applied to the case.

⁴⁹⁰ BVerfGE 93, 165, *supra* note 28, (June 22, 1995). The Inheritance and Gift Tax Law of 1934 (*Erbschaftsteuer- und Schenkungsteuergesetz*), (in the version of February 19, 1991, last amended September 27, 1994) (current version available at http://bundesrecht.juris.de/bundesrecht/erbstg_1974/index.html) applied to the case.

⁴⁹¹ Basic Law Art. 3(1). Compare, *supra* note 234 and accompanying text, discussion of *Allegheny Pittsburgh Coal Co. v. County Commission Of Webster County, West Virginia*, 488 U.S. 336.

⁴⁹² Valuation Law (*Bewertungsgesetz*), version of February 1, 1991 (current version available at <http://bundesrecht.juris.de/bundesrecht/bewg/index.html>).

⁴⁹³ BVerfGE 93 at 144 and at 176. The wealth tax has not been in effect since January 1, 1997. The inheritance tax continues to apply and the parliament amended the valuation law to use more realistic

With respect to the wealth tax, the Constitutional Court expressed concern about the level of all taxes on production and stated the principle of halves to prevent taxes from confiscating the property itself, half of the production for private use and half to public use.⁴⁹⁴ Further, in order to equalize the burden between productive and unproductive property, the court stated that all values for productive property must use an estimated, rather than an actual production, for capitalization in order to provide a level field of valuation.⁴⁹⁵ The court did not express the same confiscation concern about the inheritance tax although it did observe that the inheritance tax should not be so high as to jeopardize continuation of a going concern by diminishing its resources.⁴⁹⁶

F. Turnover Tax and the Equality Principle. Where medical unions that provided laboratory services to practitioners were exempt from the turnover tax, but independent laboratories were not, the Constitutional Court held that the preference violated the equality principle.⁴⁹⁷ The court was concerned that the turnover tax exemption provided a tax advantage that interfered with free competition. Similarly, the Constitutional Court held that the equality principle prohibits imposition of a higher turnover tax rate for medical practitioners operating through entities than on sole practitioners.⁴⁹⁸ These cases are concerned with competition between or among individuals and entities operating in the same economic activity, rather than the impact of the tax upon the consumer who bears the burden of the tax.

In other cases, the Constitutional Court has proven far less receptive to claims of unequal treatment of taxpayers under the turnover tax than under other taxes. The court held that a significantly lower turnover tax rate for small businesses with gross receipts under 60,000 German marks than for other enterprises was a reasonable exercise of legislative discretion and did not violate the equality principle. With the significant general rate increase, the legislature carved out the exception because it was concerned that the small businesses would not be able to pass the higher rate on to their customers.⁴⁹⁹ In a case addressing the credit for the pre-tax on imported milk powder, failure to adjust the computation for the specific industry, rather than using a generalized computation, did not violate the equality principle. Some inequalities were unavoidable to efficient tax administration.⁵⁰⁰ And imposition of the full rate of turnover tax on musical recordings, while reductions in rate or exemptions from the turnover tax existed for many other cultural endeavors, including books, theater productions, and concerts, did not violate the equality principle.⁵⁰¹ The court held that the legislature analyzed and

multipliers for real property in order to approximate current fair market values. Valuation Law Supp. (BewG Anlagen) 6-8 in the version last amended December 20, 2001.

⁴⁹⁴ *Id.* at 138, *supra* note 113 and accompanying text.

⁴⁹⁵ *Id.* at 137.

⁴⁹⁶ *Id.* at 176.

⁴⁹⁷ BVerfGE 43, 58 (October 26, 1976, 1st Senat).

⁴⁹⁸ BVerfGE 101, 151 (November 10, 1999, 2nd Senat).

⁴⁹⁹ BVerfGE 37, 38 (March 19, 1974, 1st Senat).

⁵⁰⁰ BVerfGE 31, 145, 179 (June 9, 1971, 2^d Senat).

⁵⁰¹ BVerfGE 36, 321 (March 5, 1974, 1st Senat).

grouped cultural activities, in part, on the basis of which activities would need a tax diminution in order to retain their profitability, a political decision properly within the expertise of the legislature. Records enjoyed a strong market position.⁵⁰² No case raised the question of the regressive impact of the turnover tax on consumers.

Part 5. Conclusion. Relative to the limited impact of U.S. Supreme Court constitutional jurisprudence on taxation, the German body of constitutional law based taxation decisions is vast. While the United States Supreme Court confirms the power of the legislature to classify taxpayers, so long as those classifications have a rational basis, the German Constitutional Court's decisions reflect near hypersensitivity to classifications of taxpayers that may limit those taxpayer's individual rights in any manner or cause some taxpayers to receive less favorable tax treatment than others. Explanatory hypotheses for these differences include:

1. That the constitutions differ, such that German constitutional protections are more robust than comparable U.S. protections, whether that robustness is intrinsic or a function of the existence of a specialized constitutional court.
2. Unlike the U.S. Supreme Court, the German Constitutional Court has no simple method like denial of *certiorari* to enable it to refuse to hear significant constitutional questions. Moreover, the German court's tunnel vision compels it to resolve constitutional questions rather than resorting to statutory grounds for a finding, so that it defers less to the legislature than does the U.S. Supreme Court. The Constitution Court may view its role as a mandate to ferret out constitutional infirmity and resolve it against the administration and legislature.
3. That, alternatively, United States constitutional protections are more durable; the Court reverses its precedents only rarely. The Supreme Court is very careful and conservative in offering constitutional protection.
4. The Supreme Court is a court of general jurisdiction and prefers to decide cases on grounds other than the Constitution rather than addressing the constitutional issue.⁵⁰³ The strong United States tradition of separation of powers causes the Court to avoid, whenever possible, conflict with the legislature and to leave most policy matters to the legislature under the Court's policy of judicial restraint.
5. That the differences reflect maturation. Earlier in U.S. constitutional history, the Supreme Court more readily struck down tax provisions but with time, it became more respectful of legislative choices. Perhaps the same development will occur in Germany as the Constitutional Court matures.

⁵⁰² *Id.* at 340-1.

⁵⁰³ *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, 341 (1936) (Justice Brandeis concurring but stating the principle that courts should dispose of cases without deciding constitutional issues whenever possible).

Support exists for each of these hypotheses.

Germany's history suggests that the first hypothesis is valid. It explains the emphasis on individual rights and the Constitutional Court's reluctance to permit any limitations of those rights. Emerging from the barbarism of its World War II period, during which the National Socialist German government mandated violation of human rights on an unprecedented scale, occupied West Germany adopted its Basic Law and established a court to protect rights under that Basic Law.⁵⁰⁴ The Basic Law confirmed Germany's present and future commitment to protection of human dignity, rule of law and absolute prohibition of discrimination. The Basic Law guarantees showed a Germany committed to distancing itself from its repressive and genocidal past and facilitated Germany's reentry into a civilized and peaceful Europe as an equal participant.⁵⁰⁵ West Germany positioned the individual rights guarantees in the Basic Law in order to give them paramount importance. Unlike the U.S. Constitution that emphasized the structure of the government and added individual rights as an afterthought in the Bill of Rights, protection of individual rights appears at the beginning of the Basic Law.⁵⁰⁶ Furthermore, the delineation of basic rights is specific with express protections of marriage, family, prohibitions on discrimination on the basis of sex, and, the first article directing all state power to protect human dignity. And, unlike most other provisions of the Basic Law, Germany prohibits emendation of the individual rights guarantees.⁵⁰⁷ While the same protections, other than sex discrimination, exist under the U.S. Constitution, many of them have emerged through constitutional interpretation.⁵⁰⁸

As to the second hypothesis, the Basic Law limits the Constitutional Court's jurisdiction to constitutional questions.⁵⁰⁹ Thus, if the court addresses a tax question at all, it must view the tax controversies in constitutional law terms. The U.S. Supreme Court, on the other hand, easily may avoid constitutional questions by determining that a taxing statute is inapplicable to a specific factual situation on technical grounds. The Supreme Court controls statutory interpretation. Furthermore, the Constitutional Court does not have the same autonomy as the Supreme Court with respect to its docket. Review by the Supreme Court generally lies within the Court's discretion.⁵¹⁰ The Basic

⁵⁰⁴ See, generally, H.W. Koch, A CONSTITUTIONAL HISTORY OF GERMANY at 342-3 (London 1984).

⁵⁰⁵ Basic Law for the Federal Republic of Germany (Agreed Anglo-American Translation) (1949). The states of West Germany adopted the Basic Law in May 1949 with the Preamble reading in part: "Conscious of its responsibility before God and mankind, filled with the resolve to preserve its national and political unity and to serve world peace as an equal partner in a united Europe, ..." The Preamble also intends the Basic Law to apply to those Germans who could not participate in the process, *i.e.*, the German Democratic Republic. Parliament amended the Preamble to include the former GDR states and to emphasize Germany as part of a united Europe following reunification in 1990.

⁵⁰⁶ Basic Law Art. 1 – 20.

⁵⁰⁷ Basic Law Art. 79 (3).

⁵⁰⁸ For example, Basic Law Art. 11 expressly guarantees the right to travel, a right established by interpretation, *inter alia*, of the 5th Amendment of the U.S. Constitution. "The right to travel is a part of the "liberty" of which the citizen cannot be deprived without due process of law under the Fifth Amendment." Kent v. Dulles, 357 U.S. 116, 125 (1958)

⁵⁰⁹ Basic Law Art. 93. The Constitutional Court's jurisdiction is slightly broader but in no way pertinent to tax law.

⁵¹⁰ Supreme Court Rule 10, *supra* note 8.

Law requires lower courts to refer constitutional issues to the Constitutional Court and suspend their proceedings until the Constitutional Court rules whenever a Basic Law interpretation is critical to resolution of a case.⁵¹¹ Lacking the luxury of non-constitutional interpretation, the German Constitutional Court either must decide the constitutional question that caused referral or determine that, contrary to the other court's analysis, the constitutional question is not critical to the case. If the Constitutional Court decides that the constitutional issue is not critical to the case, it must remand the case to the referring court even if it differs from the lower court on a substantive, but non-constitutional, issue in the case. Given that choice, the Constitutional Court may choose to exercise jurisdiction in instances in which a U.S. Supreme Court would have avoided the constitutional question.⁵¹² Perhaps the Constitutional Court, whether or not consciously, protects its own relevance by deciding issues on constitutional grounds that another court might have resolved on non-constitutional grounds.

Moreover, the Basic Law denies other courts the power to avoid constitutional issues – if a constitutional issue is significant to the case, referral of the constitutional issue to the Constitutional Court is mandatory.⁵¹³ Lest courts risk being viewed as insensitive to individual rights, they, especially early in the post-war period, may have opted to identify constitutional issues and refer the case to the Constitutional Court. Over sensitivity to constitutional matters after the war was certainly preferable to under sensitivity.

The third hypothesis emerges from the common law's reliance on a system of precedents and the rule of *stare decisis*.⁵¹⁴ Once the Supreme Court elects to decide an issue on constitutional grounds, its decision is the law of the land, despite subsequent legislative enactments. Only when the weight of later decisions that have limited or distinguished an earlier opinion makes overruling the earlier decision almost inevitable, does the Court reverse its position.⁵¹⁵ Changes in the composition of the Court may result in the Court's greater willingness to limit the holding in an earlier decision or to distinguish a case before the Court from existing precedent,⁵¹⁶ but overruling earlier decisions is exceptional: “[s]tare decisis is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right.”⁵¹⁷

⁵¹¹ Basic Law Art. 100.

⁵¹² *Spector Motor Service, Inc. v. McLaughlin*, 323 U.S. 101 (1944) (suspending decision on constitutionality of a state tax pending state court resolution of applicability of the tax); Also *Ashwander v. Tennessee Valley Authority*, 297 U.S. 288, *supra* note 503.

⁵¹³ Basic Law Art. 100.

⁵¹⁴ “To abide by, or adhere to, decided cases.” BLACK’S LAW DICTIONARY 4TH EDITION 1577 (St. Paul 1951).

⁵¹⁵ *South Carolina v. Baker*, *supra* note 159, 485 U.S. at 524 acknowledges the gradual overruling of *Pollock v. Farmers’ Loan and Trust Co.*, *supra* note 164, 157 U.S. 429 (1895), with respect to the issue of intergovernmental tax immunity.

⁵¹⁶ Consider the controversial issue of abortion. Since the decision in *Roe v. Wade*, 410 U.S. 113 (1973), only Justice Rehnquist, a dissenter, remains on the Court. Yet, while the Court has limited or distinguished subsequent cases, it has not overruled *Roe v. Wade*.

⁵¹⁷ *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (Brandeis, dissenting).

The fourth hypothesis goes to the United States' governmental system, separation of powers and judicial review. As a general policy matter, the Supreme Court avoids constitutional questions whenever possible. In abstaining from deciding a constitutional challenge to a state tax statute until the state court interprets applicability of the tax, the Court writes:⁵¹⁸

If there is one doctrine more deeply rooted than any other in the process of constitutional adjudication, it is that we ought not to pass on questions of constitutionality -- here the distribution of the taxing power as between the State and the Nation -- unless such adjudication is unavoidable.

Similarly, in a case challenging a statistical sampling the Census Bureau proposed to apportion representation in the House of Representatives, the Court concluded that the Census Act did not authorize the sampling method. Since the Court decided the case on statutory ground, it did not address the constitutional challenges.⁵¹⁹ The Court's reluctance to exercise judicial review of statutes is understandable as it places the Court into conflict with the legislature. Since the Constitution delegates the legislative function to Congress, judicial review, in the Court's tradition, remains extraordinary. Chief Justice Rehnquist emphasizes this point:⁵²⁰

Proper regard for the complex nature of our constitutional structure requires neither that the Judicial Branch shrink from a confrontation with the other two coequal branches of the Federal Government, nor that it hospitably accept for adjudication claims of constitutional violation by other branches of government where the claimant has not suffered cognizable injury.

Separation of powers is entrenched in the American legal tradition,⁵²¹ and judicial restraint is essential to prevent ongoing struggles between the branches of government.

While a similar separation of powers exists under Germany's system, parliamentary systems tend to place less emphasis on separation of powers, so that judicial restraint may not be quite so compelling as in the United States. For example, the German Constitutional Court resolved the problem that welfare recipients might receive more after tax income from welfare⁵²² than some workers with income equal to

⁵¹⁸ *Spector Motor Service, Inc. v. McLaughlin*, *supra* note 512, 323 U.S. at 105.

⁵¹⁹ *Doc v. United States House of Representatives*, 525 U.S. 316, 343 (1999).

⁵²⁰ *Valley Forge Christian College v. Americans United for Separation of Church & State*, 454 U.S. 464, 474 (1982) (plaintiff lacking standing because of no injury to itself from the purported transfer of property in violation of the establishment clause).

⁵²¹ *Marbury v. Madison*, *supra* note 7, 5 U.S. 137, 177 (1803) (establishing the Supreme Court's power to review legislative acts for constitutionality). *Clinton v. City of New York*, 524 U.S. 417, 450 (1998) (ruling "line item veto" to be unconstitutional, Kennedy concurring and discussing the importance of separation of powers).

⁵²² EStG §3 2. (exempting welfare payments from the income tax).

the amount of a welfare payment by exempting a subsistence minimum, substantially equivalent to public welfare assistance, from the income tax.⁵²³ In the United States, Congress has adjusted that problem in part with the limitation on welfare benefits in the Personal Responsibility and Work Opportunity Reconciliation Act of 1996.⁵²⁴

The fifth hypothesis may be weaker than the other hypotheses. Under the Commerce Clause, the Supreme Court's interest in preserving equality in taxation across state borders does not appear to have diminished.⁵²⁵ On the other hand, the Court increasingly tolerates small, level fees and taxes that, on equality principles, should be greater for taxpayers who use state resources more than others.⁵²⁶ The greatest number of constitutional tax decisions in both federal and state cases⁵²⁷ concentrates itself in the late 1920s through 1940, approximately. As the Court matured in its approach to taxation, taxpayers enjoyed fewer successes, although the number of successes was quite small even earlier. And the Court reversed its position on at least two issues: retroactive taxation⁵²⁸ and federal taxation of state payments.⁵²⁹ Whether the German Constitutional Court will continue its judicial activism in taxation as its body of tax decisions grows or not remains an open question.

⁵²³ BVerfGE 87, 153 (September 25, 1992, 2d Senat), *supra* note 123, discussed in text accompanying note *supra* 381.

⁵²⁴ P.L. 104-193 (104th Cong, 1st Sess., August 22, 1996).

⁵²⁵ Discussion *supra* Part 3D.

⁵²⁶ Am. Trucking Ass'ns v. Mich. PSC, *supra* note 280, 125 S. Ct. 2419 (2005).

⁵²⁷ Data exists for the federal cases, *supra* notes 155-157. The state cases are an unscientific estimate.

⁵²⁸ *Supra* notes 151-154 and accompanying text.

⁵²⁹ *Supra* Part 3E.

Appendix

A Note on Regressivity and the Income Tax Exemption/Welfare Benefit of a Subsistence Minimum

Under the German system, the combined turnover tax and income tax tends to be regressive at middle incomes but not at the lowest incomes. This characteristic is easy to illustrate through a simplified example. Assume that there is a flat rate turnover tax of 16% on all goods and services, including rent, but each taxpayer is exempt from the income tax on an amount equal to the subsistence minimum of €100. The statutory subsistence minimum is the cost per person of basic necessities – food, clothing, transportation and housing – grossed up to include the turnover tax that is an embedded, rather than an add-on, tax unlike U.S. sales taxes. Hence basic necessities cost approximately €86.20 and the tax on those necessities is approximately €13.80. On a pre-tax basis, the subsistence exemption amount applicable to all taxpayers is €86.20. Individuals whose incomes are less than €100 receive a welfare payment to increase their incomes to €100. Assume further that the minimum income tax rate is 20% and, given the steep progressivity in rates, assume a two bracket system with the higher rate of 48% on incremental Euro incomes over €300.

All taxpayers pay €13.80 of their first €100 income in combined turnover and income tax. A taxpayer with any income in excess of the subsistence amount pays at least 20% combined tax, even if he or she invests every Euro over €86. Accordingly, at the lowest incomes, the turnover tax allows no regressivity because no taxpayer will pay less than 13.8% tax on each Euro.

However, taxpayers with incomes over €100 may experience regressivity as income increases. For example, compare two taxpayers with incomes of €1000 and €2000 respectively who consume the first €1000 of income and invest any income over €1000:

€1000	€2000
1. 13.8% turnover in 1000 = €138	1. Steps 1. – 2. are same = €178
2. income tax @ 20% on 200 = € 40	2. income tax @ 48% on 1700 = €816
3. income tax @ 48% on 700 = €336	Total = €994
Total = €514	As % of €2000 total income = 49.6%
As % of €1000 total income = 51.4%	And this would drop to 48.3% at €10,000.

The regressivity begins to emerge at €1100 and becomes more pronounced as the income disparity increases.